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APPENDIX

The Tax Court of the United States

Docket No. 13943

CHRISTIAN W. KORELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Entries

[Tr. 1]

1947

May 13. Petition received and filed. Taxpayer notified. Fee paid.

May 14. Copy of petition served on General Counsel.

Jun. 18. Answer filed by General Counsel.

Jun. 18. Request for hearing at New York City filed by General Counsel.

Jun. 20. Notice issued placing proceeding on New York City calendar. Service of answer and request made.

No. 18 Hearing set Dec. 8, 1947, at New York City.

Dec. 8. Hearing had before Judge Opper on merits. Submitted. Agreed statement of facts (with joint exhibit 1-A attached) filed. Petitioner's brief due 1/7/48—respondent's 2/6/48 reply 2/24/48.

Dec. 30. Transcript of hearing of 12/8/47 filed.

1948

Jan. 2. Motion for extension to Jan. 17, 1948, to file brief filed by taxpayer. Granted.

Jan. 19. Brief filed by taxpayer—copy served.

Feb. 18. Motion for extension of 15 days to file brief filed by General Counsel. 2/19/48 granted.

Mar. 4. Brief filed by General Counsel.

28 1948

Mar. 24. Motion for leave to file the attached reply brief, brief lodged, filed by taxpayer. 3/25/48 granted.

Mar. 25. Petitioner's brief served on General Counsel.

Jun. 2. Findings of fact and opinion rendered, Opper J. Decision will be entered under Rule 50. Copies served 6/3/48.

Jul. 2. Computation of deficiency filed by General Counsel. Agreed to.

Jul. 13. Decision entered, Opper J. Div. 14.

Oct. 8. Petition for review by U. S. Court of Appeals, 2nd Circuit, filed by General Counsel.

Oct. 8. Notice of filing petition for review on Paul L. Peyton, counsel for taxpayer, filed.

Oct. 19. Proof of service filed (Paul L. Peyton).

Nov. 15. Motion for extension of time to Jan. 6, 1949 to prepare and transmit record filed by General Counsel.

Nov. 15. Order enlarging time to Jan. 6, 1949 to prepare and transmit record entered.

Dec. 28. Statement of points with proof of service thereon filed by General Counsel.

Dec. 28. Designation of contents of record on review with proof of service thereon filed by General Counsel.

* * * * *

Agreed Statement of Facts

[Tr. 11-14]

[Caption omitted]

It is hereby stipulated and agreed, by and between Christian W. Korell and the Commissioner of Internal Revenue, by their respective attorneys, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not at variance with the facts herein stipulated
29 and without prejudice to the right of either party to question the materiality of the facts herein stipulated:

1. The petitioner is an individual residing in New York, N. Y., and having an office at 50 Broadway, New York 4, N. Y.

2. During 1944, the petitioner purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3% Convertible Debenture Bonds due September 1, 1956, as follows:

August 16, 1944—$11,000 at 121⅛	$13,351.25
August 16, 1944— $2,000 at 121	2,425.00
August 22, 1944—$37,000 at 121¼	44,862.50

The average price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share and on August 22, 1944, $163.6875 per share.

3. The aforesaid bonds were issued under an Indenture between the American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941, a

true and correct copy of which is marked Exhibit 1-A and attached hereto and made a part hereof. The entire issue of the aforesaid bonds was called under the provisions of the Indenture (Exhibit 1-A) for payment as of September 1, 1947, at 104 plus interest.

4. The petitioner duly filed his return for the calendar year 1944 with the Collector of Internal Revenue for the Second District of New York and in said return claimed as a deduction in computing net income amortization of the premium paid with respect to the aforesaid bonds in the amount of $8,638.75, representing the difference between $60,638.75, the cost of the bonds as aforesaid, and $52,000, the call price thereof as set out in the attached Indenture marked Exhibit 1-A.

5. The aforesaid bonds, listed under paragraph "2" hereof, were the only premium bonds purchased or owned by the petitioner in the year 1944.

30 6. The bonds purchased by the petitioner were not part of the stock-in-trade of the petitioner, or includible in any inventory of the petitioner at the close of the taxable year, or held by the petitioner primarily for sale to customers in the ordinary course of his trade or business, but were purchased by the petitioner as an investment. The petitioner did not, during the calendar year 1944, sell any of the bonds purchased by him, as aforesaid, nor did he exercise his privilege of converting said bonds into Capital Stock of the Company.

7. In determining the deficiency herein, the Commissioner disallowed the aforesaid deduction of $8,638.75, representing amortization of bond premium claimed by petitioner as a deduction in his income-tax return for 1944.

Dated: December 5, 1947.

PAUL L. PEYTON,
Counsel for Petitioner.

(Signed) CHARLES OLIPHANT,
RPH.
Chief Counsel, Bureau of Internal Revenue.

31 *Excerpts From Indenture Dated September 1, 1941*

(Exhibit 1-A)

[Tr. 15]

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

AND

CITY BANK FARMERS TRUST COMPANY, TRUSTEE

Indenture dated September 1, 1941

* * * * *

[Tr. 52–53]

Section 3.01. The Company may, at its option, redeem all or from time to time any part of the Debenture Bonds on any date on or after September 1, 1942, and prior to maturity at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter 100%.

* * * * *

[Tr. 56–57]

Section 4.01. The holder of any Debenture Bond or Debenture Bonds shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or De-
32 benture Bonds), to convert, subject to the terms and provisions of this Article, the principal of any such Debenture Bond or Debenture Bonds into such number of full-paid and nonassessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond or Debenture Bonds surrendered for conversion is a multiple of $100 (such amount of $100 or, in case of any adjustment of such amount pursuant to the provisions of Section 4.05, then such adjusted amount, being hereinafter referred to as the "basic bond price") at the price of $140 per share (such amount of $140, or, in case of any adjustment of such amount pursuant to the provisions of Section

4.04, then such adjusted amount, being hereinafter referred to as the "conversion price") upon (i) payment to the Company for each such share of Capital Stock of cash in an amount equal to the amount by which the conversion price exceeds the basic bond price and (ii) surrender of the Debenture Bond or Debenture Bonds the principal of which is so to be converted to the Company at the office or agency to be maintained by the Company in accordance with the provisions of Section 5.02, will all unmatured coupons, if any, thereto appertaining, and, in the case of registered Debenture Bonds without coupons and of coupon Debenture Bonds which shall at the time be registered as to principal, accompanied by instruments of transfer in form satisfactory to the Company, duly executed by the respective registered holders thereof or by their duly authorized attorneys. For convenience, the conversion of the principal of any Debenture Bond or Debenture Bonds into the Capital Stock of the Company is hereinafter sometimes referred to as the conversion of such Debenture Bond or Debenture Bonds.

* * * * * *

33 [Tr. 59–64]

Section 4.04. The conversion price specified in Section 4.01 shall be subject to adjustment from time to time as follows:

A. In case the Company shall at any time after the date of the execution of this Indenture (1) issue any shares of Capital Stock (other than upon conversion of the Debenture Bonds) without consideration, as a dividend or otherwise, or for a consideration per share less than the conversion price in effect immediately prior to the issuance of such additional shares or (2) declare any dividend, other than a dividend payable in cash or in shares of Capital Stock of the Company, then, and thereafter successively upon each such issuance and each such dividend declaration, the conversion price in effect immediately prior to the issuance of such additional shares or the declaration of such dividend, shall forthwith be reduced to a price determined by dividing

(1) an amount equal to (a) the total number of shares of Capital Stock outstanding immediately prior to such issuance or the declaration of such dividend multiplied by the conversion price in effect immediately prior to such issuance or the declaration of such dividend, plus (b) the consideration, if any, received by the Company upon such issuance or less (c) the aggregate of the amount of such dividend then being declared, by

(2) the total number of shares of Capital Stock outstanding immediately after the issuance of such additional shares or the declaration of such dividend.

Anything in this Article Four to the contrary notwithstanding, the Company shall not be required to make any adjustment of the conversion price in any case in which the amount by
34 which such conversion price would be reduced in accordance with the foregoing provisions of this Section 4.04 would be less than $2.00 (or, in the event of any adjustment of the basic bond price pursuant to Section 4.05, such other amount as is in the same proportion to the adjusted basic bond price as the amount of $2.00 is to the original basic bond price of $100), but in such case any adjustment or adjustments so carried forward, shall amount shall be carried forward and shall be made at the time of and together with the next subsequent adjustment, which, together with any adjustment or adjustments so carried forward, shall amount to not less than $2.00 or not less than such other amount as shall then be in effect.

For the purposes of this Subdivision A, the following provisions shall also be applicable:

(1) In case of the issuance of additional shares of Capital Stock for cash, the consideration received by the Company therefor shall be deemed to be the amount of cash received by the Company for such shares, before deducting therefrom any commissions or other expenses paid or incurred by the Company for any underwriting of, or otherwise in connection with, the issuance of such shares.

(2) In case of the issuance (otherwise than upon conversion or exchange of obligations or shares of stock of the Company) of additional shares of Capital Stock for a consideration other than cash or a consideration a part of which shall be other than cash, the amount of the consideration other than cash received by the Company for such shares shall be deemed to be the value of such consideration as determined by the Board of Directors.

(3) In case of the issuance of additional shares of Capital Stock upon conversion or exchange of any obligations or of any shares of stock of the Company that shall be convertible into or
35 exchangeable for shares of Capital Stock, the amount of the consideration received by the Company for such additional shares of Capital Stock shall be deemed to be the amount of the consideration received by the Company upon the original issuance of such obligations or shares so converted or exchanged, plus the consideration, if any, other than such obligations or shares, received by the Company upon such conversion or exchange, except in adjustment of interest and dividends. The amount of the consideration received by the Company upon the original issuance of such obligations or shares so converted or exchanged and the amount of the consideration, if any, other than such obligations or shares, received by the Company upon such conversion

shall be determined in the manner provided in paragraphs (1) and (2) above; provided, however, that if such obligations or shares of stock so converted or exchanged shall have been issued as a dividend upon any stock of the Company, the amount of the consideration received by the Company upon the issuance of such additional shares of Capital Stock shall be deemed to be the value of such obligations or shares of stock, as of the date of the adoption of the resolution declaring such dividend, as determined by the Board of Directors of the company at or as of that date, plus the consideration (determined in the manner provided in paragraphs (1) and (2) above), if any, other than such obligations or shares, received by the Company upon such conversion or exchange, except in adjustment of interest and dividends.

(4) In case of the issuance of additional shares of Capital Stock as a dividend, the aggregate number of shares of Capital Stock issued in payment of such dividend shall be deemed to have been issued on the record date fixed for the determination of stockholders entitled to such dividend and shall be deemed to have been issued without consideration.

36 (5) The amount of a dividend in property (including obligations of the Company) or in shares of stock (other than Capital Stock of the Company) shall be deemed to be the value of such property or shares of stock, as of the date of the adoption of the resolution declaring such dividend, as determined by the Board of Directors of the Company at or as of that date.

(6) The term dividend shall mean a dividend or other distribution upon stock of the Company.

(7) The number of shares of Capital Stock at any time outstanding shall include all shares of Capital Stock then owned or held by or for the account of the Company.

B. In case the Company shall at any time subdivide the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the conversion price in effect immediately prior to such subdivision shall be proportionately decreased, and in case the Company shall at any time combine the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the conversion price in effect immediately prior to such combination shall be proportionately increased.

C. Whenever the conversion price is adjusted, as herein provided, the Company shall forthwith file with the Trustee a statement signed by the President or a Vice-President of the Company and by its Treasurer or an Assistant Treasurer, showing in detail the facts requiring such adjustment, and the adjusted conversion price determined as provided herein. Subject to the provisions of Section 8.01 hereof, the Trustee shall be under no duty or responsi-

bility with respect to any such statement except to exhibit the same from time to time to any bondholder desiring an inspection thereof.

37 Section 4.05. The basic bond price specified in Section 4.01 shall be subject to adjustment from time to time as follows:

A. In case any adjustment of the conversion price pursuant to Subdivision A of Section 4.04 shall result in the reduction of the conversion price to an amount less than the basic bond price in effect immediately prior to such reduction of the conversion price, then, and thereafter successively in the case of each reduction of the conversion price pursuant to said Subdivision A, the basic bond price in effect immediately prior to such reduction of the conversion price shall forthwith be reduced to an amount which shall be equal to the conversion price as so reduced.

B. In case the Company shall at any time subdivide the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the basic bond price in effect immediately prior to such subdivision shall be proportionately decreased, and in case the Company shall at any time combine the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the basic bond price in effect immediately prior to such combination shall be proportionately increased.

C. Whenever the basic bond price is adjusted, as herein provided, the Company shall forthwith file with the Trustee a statement signed by the President or a Vice-President of the Company and by its Treasurer or an Assistant Treasurer, showing in detail the facts requiring such adjustment, and the adjusted basic bond price determined as provided herein. Subject to the provisions of Section 8.01 hereof, the Trustee shall be under no duty or responsibility with respect to any such statement, except to exhibit the same from time to time to any bondholder desiring an inspection thereof.

* * * * *

38 [Tr. 68–69]

Section 5.02. As long as any of the Debenture Bonds remain outstanding, the Company will maintain an office or agency in the Borough of Manhattan, The City of New York, where the Debenture Bonds may be presented for registration, transfer, exchange and conversion as in this Indenture provided, and where notices and demands to or upon the Company in respect of the Debenture Bonds and coupons or of this Indenture may be served,

and where the Debenture Bonds and Coupons may be presented for payment. The Company will give to the Trustee notice of the location of any such office or agency and of any change of location thereof. In case the Company shall fail to maintain such office or agency or shall fail to give such notice of the location or of any change in the location thereof, presentations and demands may be made and notices may be served at the principal office of the Trustee in the Borough of Manhattan, the City of New York.

* * * * *

Findings of Fact and Opinion

[Tr. 138–142]

[Caption omitted]

* * * * *

This proceeding was brought for a redetermination of a deficiency in income tax for the year 1944 in the amount of $5,218.84. Minor adjustments have been conceded by petitioner and the litigated issue is whether respondent erred in disallowing the deduction claimed by petitioner in the taxable year under Internal Revenue Code, sections 23 (v) and 125, as amortization of the premium over the call-price of certain bonds.

39 *Findings of Fact*

All the facts are stipulated and are hereby found accordingly.

Petitioner, an individual, filed his income-tax return for the period in question with the collector of internal revenue for the second district of New York.

During 1944 petitioner purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3-percent convertible debenture bonds, due September 1, 1956, as follows:

August 16, 1944—$11,000 at 121⅛	$13,351.25
August 16, 1944—$2,000 at 121	2,425.00
August 22, 1944—$37,000 at 121¼	44,862.50

The average market price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share.

These bonds were issued under an indenture between American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941. The indenture provided in part that on not less than thirty days' notice the bonds

might be redeemed by the Company in whole or in part on any date on or after September 1, 1942, "at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter, 100%."

The indenture further provided that the holder of any debenture bond "shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds) to convert * * * the principal of any such Debenture Bonds * * * into such number of full-paid and nonassessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *," by the surrender of $100 principal amount of debenture bonds and payment to the Company of cash equal in amount to the excess of the conversion price over $100.

The entire issue of these bonds was called for payment under the provisions of the indenture as of September 1, 1947, at 104, plus interest.

In his return for the taxable year petitioner claimed as a deduction, in computing net income, amortization of the premium paid with respect to his bonds in the amount of $8,638.75, representing the difference between $60,638.75—the cost of the bonds—and $52,000—the call price of the bonds at 104.

These bonds were the only premium bonds purchased or owned by petitioner in 1944. They were not part of the stock-in-trade of petitioner or includible in any inventory of petitioner at the close of the taxable year, or held by him primarily for sale to customers in the ordinary course of his trade or business, but were purchased by petitioner as an investment.

Petitioner, in 1944, did not sell any of the bonds or exercise his right of converting them into capital stock of the Company.

Opinion

OPPER, *Judge:* When the coupon rate of interest carried by a bond issue exceeds the going rate for obligations of comparable desirability, the market will tend to place a premium on the bonds. If bonds are purchased for investment under such circumstances,

the premium paid must be recovered tax-free out of the earnings of the bond [11] very much as depreciation must be recovered out of the income of depreciable property if the true distinction
41 between income and recovery of capital is to be preserved. Cf. *United States* v. *Ludey*, 274 U. S. 295. With this objective in mind,[12] Congress in 1942 added provisions to the Internal Revenue Code permitting the amortization of bond premium by deductions from gross income.[13]

42 A complication bound to arise was the amortization of premium on bonds callable prior to maturity. Such obligations although not included in the statute are covered in a subdivision of the regulations dealing with "Callable and Convertible Bonds." [14]

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[11] "• • • The difference between the yield and the actual interest rate is simply a return of capital and should be treated as such rather than as a capital loss." (Statement of Randolph Paul, Tax Adviser to the Secretary of the Treasury, Hearings before the Committee on Ways and Means on Revenue Revision of 1942, p. 90.)

[12] "Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provisions should be made for their avoidance.

"The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. Holders of taxable bonds not only pay a tax, as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital 'lost' at maturity. Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it.

"The treatment proposed is mandatory to all taxpayers with respect to wholly tax-exempt bonds and elective to all with respect to bonds fully taxable. In the case of partially tax-exempt bonds, it is mandatory to corporate taxpayers and elective to all other taxpayers.

"The amortization provision is found in section 119 of the bill and its operation is described in detail later in this report." (H. Rept. No. 2333, 77th Cong., 2d Sess., p. 47).

[13] "SEC. 23. • • •

"(v) *Bond premium deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125."

"SEC. 125. AMORTIZABLE BOND PREMIUM.

"(a) *General rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

"(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction,

• • • • • •

"(b) Amortizable bond premium.—

"(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

"(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

"(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

"(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

"(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

[14] Regulations 111:

"SEC. 29.125-5. *Callable and convertible bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date

43 The debentures purchased by petitioner in the tax year and which form the subject of this controversy were both callable and convertible. They were currently callable at the option of the obligor at any time on thirty days' notice at 104 percent of face. They were convertible at any time at the option of the holder into common stock of the obligor upon payment of the difference between the face of the bond and 140 percent of par.

Petitioner purchased the debentures at approximately 121 when the common stock of the obligor was selling at 163. Relying upon his interpretation of the statute and the regulations, petitioner deducted the difference between 104, the call price, and 121, his purchase price or basis, as a premium. The entire deduction was taken in the year before us, on the theory that the bond could have been called in that same year, and that in that event the entire premium would have been lost.

Respondent does not dispute such treatment in the case of a bond callable within the current year, but rejects petitioner's claim here because of the convertible feature of the debentures. His position was set forth in a ruling issued in 1945, dealing with the same issue of debentures as that now in controversy.[15]

44 Respondent's reasoning to justify rejection of the claimed deduction is not without force. He says in effect that what Congress was dealing with when it enacted section 125 was, as we

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will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date, if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof."

[15] "* * * If the call provisions of these bonds were to be considered wholly apart from other attendant circumstances, the taxpayer might select the 31st day after the date of purchase as the 'earlier call date,' even though the bonds were not actually called on that date or notice of call had not been given.

"Section 29.125-5 of Regulations 111, provides, however, that the fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. The qualification in itself indicates that other factors may arise which would preclude the application of section 125 of the Code to such bonds.

"The bonds have been selling for approximately 123 and the common stock of the American Telephone and Telegraph Company has been selling for about 163. It will thus be seen that the $123.00 cost of such bond plus the $40.00 conversion fee equals $163.00, the same price for which the stock can be purchased on open market. For nearly two years, the market price of those bonds has fluctuated almost directly in accordance with the quotations on the common stock into which such bonds are, at any time, convertible. This clearly indicates that substantially all of the so-called premium of $23.00 represents the market value of the conversion option, rather than a premium paid for the investment value of the security itself, considered independently of the conversion option. This $23.00, therefore, is not a true bond premium such as would normally be amortized out of gross interest earnings in order to exclude capital recovered under the guise of interest and thus determine the effective yield of the security.

"This office is accordingly of the opinion that the excess of the amount of the basis of these bonds over the amount payable at maturity may not be amortized under section 125 of the Internal Revenue Code. * * *" (1945 P. H., ¶ 76, 157; 1945 C. C. H., ¶ 6139).

have seen, the investment premium paid in excess of the call or maturity price of an obligation which was required to be paid in order to purchase interest income. Respondent's regulations, to be sure, do not provide that no bond "convertible into stock" is within the definition of an amortizable obligation, but that "the fact that a bond is * * * convertible into stock does not, in itself, prevent the application of section 125." [16] This, however, advances us only to the point that the mere aspect of convertibility may not necessarily affect the possibility of the payment of an investment premium. Such would be the situation where the relationship between the conversion figure and the market price of the obligor's stock, eliminated value from the conversion privilege. See Badger,[17] "Valuation of Industrial Securities," 42. But in the present case, both the call price and the conversion figures indicate that the premium was paid, not for the investment feature of the bond, but for the rights of conversion.

The final reference in the regulation to a convertible obligation is that contained in the last sentence of the subdivision previously quoted,[18] reading as follows:

"* * * A convertible bond is within the scope of section 125 if the option to convert [on a date certain specified in the bond] rests with the holder thereof."

If this statement could be taken as fairly interpretative, and whatever its meaning may be,[19] it seems clear that it could, under no circumstances, apply to these facts, and hence could be disregarded here. The debentures held by petitioner were convertible on any date from the minute he acquired them to their possible future call for redemption and consequently not on "a date cer-

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[16] See footnote 4, *supra*.

[17] "* * * The value of convertible bonds is, in fact, dependent on either one of two factors. As long as the value of the issue into which the bond is convertible remains below the point where conversion is profitable, just so long will the value of the bond be dependent entirely on its investment status. When the value of the former rises, however, the value of the convertible issue is a function of two factors, the rate of conversion and the price of the issue into which it may be converted. This may be expressed mathematically as follows:

Investment value of convertible issue	I
Conversion rate	R
Market price of stock	P
Value of convertible bond	V

I determine V if I is greater than $\frac{P}{R}$; Otherwise $V = \frac{P}{R}$."

[18] See footnote 4, *supra*.

[19] Respondent suggests the following in his brief as an example of the purpose of that portion of the regulations (p. 22):

"A bond callable at any time on 30 days' notice, is convertible into stock only on January 1, 1910 (a date certain specified in the bond). It would be possible for the issuer, by exercising the call privilege, to defeat the bondholder's conversion right so that any premium paid for the bond might be lost thereby. This might justify the allowance of the deduction for amortization of premium where conversion is provided for on a date certain specified in the bond; whereas, when no date certain is specified, the holder of the bond would be protected by his right to convert, which could not be defeated by the mere exercise of the call privilege."

tain." The result of this sentence would then be neutral and leave open for consideration the question whether the section covered such convertible bonds as those held by petitioner.

The difficulty with respondent's entire position, however, is that it ignores the interpretation which Congress itself placed upon the legislation. In both the Ways and Means Com-
46 mittee and Finance Committee reports,[20] there appears in identical language the following:

"The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, *if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of the section.*" [Emphasis added.]

The final statement is unequivocal and precisely includes the bonds in controversy. Petitioner's application of the provision to his situation and his computation of the deduction are thus squarely justified by the expression of congressional intent. The portion of the sentence of the regulation quoted above which is enclosed in brackets appears to be a gratuitous addition by respondent not founded upon the statutory language and directly in conflict with its legislative history. We are accordingly unable to ascribe to it the validity which would result in authorizing respondent's position in this proceeding. We see no choice but to disapprove the deficiency.

Reviewed by the Court.

Decision will be entered under Rule 50.

47 *Decision*

[Tr. 143]

[Caption omitted]

Respondent having on July 2, 1948, filed a recomputation of tax for entry of decision as in accordance with Findings of Fact and Opinion of the Court, promulgated June 2, 1948, and petitioner having concurred therein, now, therefore, it is

[20] H. Rept. No. 2333 (77th Cong., 2nd Sess.), p. 80. S. Rept. No. 1631 (77th Cong., 2nd Sess.), p. 94.

Ordered and Decided: That there is a deficiency in income tax for the year 1944 in the amount of $216.97.

(Signed) CLARENCE V. OPPER,
Judge.

Enter: Jul. 13, 1948.

* * * * * *

Statement of points to be relied upon

[Tr. 146–147]

In the United States Court of Appeals for the Second Circuit

T. C. Docket No. 13943

COMMISSIONER OF INTERNAL REVENUE, PETITIONER ON REVIEW

v.

CHRISTIAN W. KORELL, RESPONDENT ON REVIEW

Statement of points

Now comes the Commissioner of Internal Revenue, the petitioner on review herein, by his attorneys, Theron L. Caudle, Assistant Attorney General, and Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and hereby asserts the following errors on which he intends to rely in this review:

The Tax Court of the United States erred:

1. In holding and deciding that the premiums paid for bonds callable for redemption on 30 days' notice is
48 amortizable in full in year of acquisition under Sections 23 (v) and 125 of the Internal Revenue Code, notwithstanding the premium may have been due entirely to accompanying privilege of converting into obligor's stock at a price below current market value.

2. In holding and deciding that the phrase appearing in Sec. 29.125–5 of Regulations 111 "on a date certain specified in the bond" is a gratuitous addition by the Commissioner not founded upon the statutory language and is directly in conflict with its legislative history.

3. In failing to reject the petitioner's claim for amortization of bond premiums because they were not true bond premiums within the intendment of the Statute and Regulations, such as would normally be amortized out of gross interest earnings in order to exclude capital recovered under the guise of interest.

4. In failing to hold and decide that no part of the so-called premium on the 15-year 3% convertible debenture bonds of the American Telephone & Telegraph Co. was deductible in the year 1944 under Sections 23 (v) and 125 of the Internal Revenue Code as amortization of the premium over the call price for the reason that the excess of the purchase price over par represented the market value of the conversion option and was not a true bond premium.

5. In entering its decision wherein it ordered and decided that there is only a deficiency of $216.97 in income tax for the year 1944.

6. In that its decision is not supported by the evidence.

7. In that its decision is contrary to law and regulations.

(S) THERON L. CAUDLE,
Assistant Attorney General,
(S) CHARLES OLIPHANT,
Chief Counsel,
Bureau of Internal Revenue,
Counsel for Petitioner on Review.

49 Service of a copy of this statement of points is hereby admitted this 9th day of December 1948.

(S) PAUL L. PEYTON,
15 Broad Street, New York 5, New York,
Counsel for Respondent on Review.

1481 United States Court of Appeals for the Second Circuit

No. 202—October Term, 1948

(Argued May 11, 1949—Decided June 8, 1949)

Docket No. 21225

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

Before: CHASE, CLARK and DOBIE, *Circuit Judges.*

On petition for review of the decision of the Tax Court of the United States

Petition by the Commissioner of Internal Revenue for review of a decision of the Tax Court of the United States, 10 T. C. 1001, disallowing a deficiency he had assessed in the federal income tax of Christian W. Korell for the year 1944. Decision affirmed.

1482 FRED E. YOUNGMAN, Sp. Asst. to the Atty. Gen., of Washington, D. C. (Theron Lamar Caudle, Asst. Atty. Gen., and Ellis N. Slack and Robert N. Anderson, Sp. Assts. to the Atty. Gen., all of Washington, D. C., on the brief), *for petitioner.*

PAUL L. PEYTON, of New York City (John J. Fogarty and Frederick H. Bruenner, both of New York City, on the brief), *for respondent.*

CLARK, *Circuit Judge:*

This case presents a problem as to the nature of the "amortizable bond premium" which was first allowed as a deduction from gross income for federal income-tax purposes in 1942. The taxpayer has claimed such a deduction on his 1944 tax for the excess cost to him, over the amounts payable, of certain bonds which were callable at the debtor's option and convertible at his option into shares of the debtor's stock. His contention has been sustained by the Tax Court as against the Commissioner's contention that the statutory deduction is allowable only for a "true bond premium" and that the excess of cost in the case of convertible bonds of the kind here in issue is not of that nature.

Judge Opper for the Tax Court has written a carefully reasoned opinion, 10 T. C. 1001, which was reviewed by the whole court and which we think fully meets the issues presented by the Commissioner. In it he states the facts, which were stipulated, the rather lengthy statutory provision and treasury regulations, and certain of the committee reports explaining the statutory provision when it was adopted. Since the material is thus available, we
1483 shall merely refer to it where apposite without full quotation.

In August, 1944, respondent purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3 percent convertible debenture bonds, due September 1, 1956, at prices ranging from $121 to $121¼ per $100 principal and a total cost of $60,638.75. At that time the bonds were subject to call by the company on thirty days' notice at 104%; and, indeed, they were so called and paid on September 1, 1947. In his 1944 return, respondent claimed as a deduction the amount of $8,638.75, representing the difference between the cost, stated above, and the call price of $52,000. It is this deduction which the Commissioner disallowed in making his deficiency assessment and which is restored by the decision of the Tax Court, now before us on the Commissioner's petition for review.

To round out the picture, certain additional facts must be adverted to; indeed, these become crucial to the discussion. Under the terms of the bond respondent had the option, during all times

here important, of converting the bonds into stock of the company by surrendering $100 principal of the bond issue and $40 in cash in exchange for each share of stock received. On the dates when he purchased the bonds the average selling price of the stock was $163.1875 and $163.6875 per share. The Commissioner, in arguing that the excess paid for the bonds here over their face value represented the value of the conversion rights, stresses the correspondence in value between the price of each bond plus $40 and the current quotation for the stock into which it could be converted. He adds that "it would be naive to assume that the bonds here involved were purchased at such exorbitant prices purely for investment purposes." We shall avoid the charge of naiveté by expressing no dissent; whatever respondent may actually have done with these bonds after 1944, certainly it would be
1484 perfectly normal to expect a holder to sell them in due course after the proper interval to take advantage of the lower rates for capital gains.[1] And the obvious advantage, taxwise, of transactions of this form might make such convertible bonds all the rage of security markets. Nevertheless the difficulties of a judicial attempt to remodel legislation to deal with such a situation at once fairly and not overdestructively remain obvious.

Let us then turn to the statute which still remains the best indicator of the legislative intent. *Ex parte Collett*, S. Ct., May 31, 1949; *Gemsco v. Walling*, 324 U. S. 244, 260. After having provided for the deduction of "amortizable bond premium," 1 R. C. § 23(v), it goes on to define the latter. I. R. C. § 125, as added by § 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798. In summary it provides that the "amount of bond premium" shall be determined with reference to the (in this case) cost and the "amount payable on maturity or on earlier call date," and "the amortizable bond premium" of the taxable year shall be "the amount of the bond premium attributable to such year." I. R. C. § 125 (b) (1) and (2). As Judge Opper has stated the objective, "the premium paid must be recovered tax-free out of the earnings of the bond very much as depreciation must be recovered out of the income of depreciable property if the true distinction between income and recovery of capital is to be preserved."[2] Finally subd. (d), "Definition
1485 of Bond," provides: "As used in this section, the term 'bond' means any bond, debenture, note, or certificate or other

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[1] Such course, we are told, was actually followed by another taxpayer as to this same bond issue in a case where likewise the Tax Court reversed the Commissioner. *Khoong v. Commissioner*, 1948 Prentice Hall T. C. Memorandum Decisions, ¶ 48,095, now pending on appeal to the Court of Appeals for the Ninth Circuit.

[2] "Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance." H. R. Rep. No. 2333, 77th Cong., 2d Sess., 47, 1942, quoted by the Tax Court below.

evidence of indebtedness, issued by any corporation and bearing interest," and then goes on to exclude bonds constituting stock in trade of the taxpayer or held primarily for sale to customers in the ordinary course of business.

Thus it will be seen that there is here provided a complete statutory scheme applying in general terms to all forms of bonds, including—as is shown by the reference to the "call date"—callable bonds. Hence there is no sound basis for excluding from the operation of the statute convertible bonds, even though the premium paid on them might well be due more to the privilege of conversion than to other features, such as the callability of the bonds at a premium. And this, it is made clear by the Committee Reports, was the view of the legislators, for they so state in language relied upon by the Tax Court, so directly to the point that we shall quote it, *viz:* "The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, if the option to convert the bond into sock rests with the owner of the bond, the bond is within the purview of this section." H. Rep. No. 2333, 77th Cong., 2d Sess., 80 (1942–2 Cum. Bull. 372, 433, 434); Sen. Rep. No. 1631, 77th Cong., 2d Sess., 94 (1942–2 Cum. Bull. 504, 576).

The intent therefore to include convertible bonds generally within the operation of the statute cannot be questioned, and the Commissioner is really forced to the rather extreme posi-
1486 tion of saying that only the particular type of convertible bond here in issue does not have the "true bond premium," which alone, according to his view, is to be amortized. For this he cites as significant the precise wording of an applicable Treasury Regulation. In fact, the section, after permitting "the method of amortizing bond premium regularly employed by the holder of the bond" to be used "if such method is reasonable," then provides that the method in all other cases shall be "in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary." I.R.C. § 125 (b) (3) (A) and (B). This appears to concern more the method of computing the yearly deductions than the allowance of the deductions themselves. At any rate, § 29.125 of Treas. Reg. 111 contains extensive and detailed provisions which, *inter alia*, accept complete application of the section to both callable and convertible bonds. The provision most in point here, subsec. 5 of § 29.125 of Treas. Reg. 111, first states:

"The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125." It then goes on to provide that in the case of a callable bond the earlier call date is considered the maturity date for application of the statute and for the spreading of the bond period over the period involved.[4] It concludes, "A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof." This last sentence (and particularly the words "on a date certain") is the one about which discussion has hinged.

1487 In its decision the Tax Court concluded that the words involved appear to be "a gratuitous addition by respondent not founded upon the statutory language and directly in conflict with its legislative history." Accordingly it found itself unable to ascribe to the provision the validity which would result in supporting petitioner's position herein. Petitioner now assails this holding as in itself gratuitous in that the language, "does not necessarily exclude bonds convertible at any time by the holder," and the exclusion should be considered accomplished by definition of "true bond premium" within the meaning of the statute itself. We can well agree with the argument that these words do not necessarily reach our case, which may be one not specifically covered by the regulations beyond the generality of statement elsewhere contained in them. But that gets us little further along, for we must still give effect to the statute which contains no suggestion of the narrowing concept now urged to be a part of it. Nor does petitioner suggest any definition of his concept of sufficient precision so that it could safely be relied on by taxpayers or revenue enforcing authorities hereafter. In short, the narrow rule of exclusion does not appear to us as justifiable either on grounds of equity or as a reasonable interpretation of the statutory language. The particular option which is relied on to remove the transaction from the statutory grant is at most only a bit more extensive—or more valuable—than one admittedly within it. The difference is thus one merely of degree and not of kind. Indeed, the difficulty with petitioner's position is that it requires the making of narrow and quite possibly unfair distinctions between varying bond issues without warrant in the general language employed or in the legislative history. Why should a bond callable at 107 (as these originally were) have this tax option denied to a holder thereof only when it is accompanied by the grant

[4] Hence the taxpayer here properly treated as the earliest call date for his bonds the date which was thirty-one days subsequent to his purchase and therefore he deducted the entire premium as a loss during the year 1944—a method of computation which is not challenged by the petitioner.

1488 of a privilege to convert into stock, or more particularly only when it is accompanied by the grant of such privilege of conversion when it is exercisable at any time, instead of at a future specified time or interval of time? To attempt to make such distinctions in a statute so broadly and generally worded seems to us to be trespassing beyond the judicial, and upon the legislative, process.

Affirmed.

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 8th day of June one thousand nine hundred and forty-nine.

Present: Hon. HARRIE B. CHASE, Hon. CHARLES E. CLARK, Hon. ARMISTEAD M. DOBIE, *Circuit Judges*.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

Appeal from the Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

ALEXANDER M. BELL,
Clerk.

United States Court of Appeals, Second Circuit

COMMISSIONER OF INTERNAL REVENUE

v.

CHRISTIAN W. KORELL

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Judgment

United States Court of Appeals, Second Circuit. Filed June 8, 1949. Alexander M. Bell, Clerk.

No. 21225

In the United States Court of Appeals for the Second Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KOSELL, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

PETITION FOR REHEARING

United States Court of Appeals, Second Circuit. Filed June 24, 1953. A. M. Bell, Clerk.

1 In the United States Court of Appeals for the Second Circuit

No. 21225

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

Petition for rehearing

To the Honorable United States Court of Appeals for the Second Circuit and to the Judges Thereof:

Comes now the petitioner, the Commissioner of Internal Revenue, and in accordance with Rule 28 of this Court presents his petition for rehearing.

This case was argued on May 11, 1949. An opinion was filed June 8, 1949, affirming the decision of the Tax Court, disallowing a deficiency assessed for the year 1944.

This Court determined that the approximate sum of $17 per bond paid in excess of the call price was "amortizable bond premium" within the meaning of Section 125 of the Internal Revenue Code, despite the fact that it was patent that the excess price was paid as consideration for the privilege of purchasing stock

2 at approximately $20 below the market price. It is respectfully submitted that the determination of this Court on the novel question presented was based upon a serious and fundamental misconception as to the nature of the deduction intended by Congress. In the view of the Commissioner the error of this Court is three-fold. First, the Court failed to give effect to the relevant legislative history which demonstrates conclusively that the excess payments made here are not "amortizable bond premium" within the meaning of the statute and cannot conceivably serve as the basis of the claimed deduction when once the purpose of the statute is understood. Secondly, the Court appears to have erred in so far as it indicated that the construction of the statute urged by the taxpayer was required by the language of Section 125; whereas in fact Section 125 contains no definition of "amortizable bond premium" but states only the method of computing the amount of the premium. Thirdly, the Court apparently misconceived the basis of the Commissioner's contention,

attributing to the Commissioner a reliance on certain Treasury Regulations to support the contention that the amount claimed as a deduction was not bond premium. The consequence of this misconception is that the Commissioner's real contention has not as yet been satisfactorily answered either by the taxpayer, the Tax Court, or this Court.

1. The decision of this Court attributes to the term "amortizable bond premium" a meaning not only out of harmony with the concept as commonly understood but which is furthermore wholly unwarranted by and indeed in the teeth of the demonstrated legislative intent in granting the deduction claimed here. "Amortizable bond premium" is the excess payment over the call price of a bond which has been paid in order to obtain a rate of in-
3 terest in excess of the average market yield, and which is thus reflected and included in each distribution of bond "interest". Bond premium is not any payment over the call price made in conpection with the purchase of a bond regardless of the nature or purpose of the payment. It is not a payment manifestly made for an option to purchase stock as that here involved. Even were the legislative history unconvincing it could be demonstrated that as a matter of common understanding a bond premium represents the excess capital paid to obtain a higher rate of interest. That this was the meaning intended by Congress is conclusively demonstrated by the Report of the House Ways and Means Committee (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 47 (1942–2 Cum. Bull. 37[illegible]410)) setting forth the reason for the deduction of "amortizable bond premium" as follows:

"Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance.

"The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. *Holders of taxable bonds not only pay a tax as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital 'lost' at maturity.* Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it." [Italics ours.]

4 The Committee Report demonstrates that bond premium is that capital which has been paid to obtain a higher rate

of interest than the average market yield and which is thus included as a portion of each of the interest payments. As the Committee Report points out, the purpose of the deduction claimed here was to allow the taxpayer to recover out of the interest earnings that portion of the purported interest which was really capital or premium. In the instant case it may be observed that the 3% interest paid on the bonds was the average rate of interest. It was only interest and included no capital to be recovered. This followed from the fact that the payments made in excess of the call price in connection with the purchase of the bonds were not made to obtain above average interest but were made for the purchase of what were in essence stock options. In short, the payments were not bond premium; they were in no wise reflected or included in the interest distributions; and no reason existed to allow for the recovery out of interest of that which was not attributable to or in any way reflected in the interest.

That Congress used the term "amortizable bond premium" in the sense urged by the Commissioner in enacting Section 125 is further demonstrated by the testimony of Randolph Paul, in his capacity as Tax Advisor to the Secretary of the Treasury, given before the House Ways and Means Committee, and explaining the nature of the deduction contemplated and the reason for granting it. His testimony as set forth before the House Ways and Means Committee (House Hearings on the Revenue Act of 1942, Vol. I, p. 90) appears as follows:

"(d) *Amortization of bond premium.*—Holders of a tax-exempt security purchased at a premium are today in the unique position of being relieved of tax on the interest paid on the security and of receiving a deductible loss upon redemption or other disposition of the security to the extent of the premium. As *the premium at which a bond is obtained represents to the holder* merely an *effective yield lower than the actual interest rate*, the holder is entitled merely to tax exemption solely with respect to such effective yield. *The difference between the yield and the actual interest rate is simply a return of capital and should be treated as such rather than as a capital loss.* On the other hand, the holder of a taxable security purchased at a premium is in the unfortunate position of being taxed upon the interest at high rates and of receiving a capital loss upon redemption whose deductibility is subject to the restrictions placed upon capital losses. *Since the yield rather than the actual interest rate reflects the true income to the taxpayer, only that income should be subject to tax and the capital loss should disappear.*

"*Proper tax treatment in both situations may be obtained through amortization of the premium.* It is suggested that such amortization be mandatory for wholly tax-exempt securities and

for partially tax-exempt securities held by a corporation. For all other securities the amortization should be at the taxpayer's election." [Italics supplied.]

As Mr. Paul points out, the premium represents the amount paid to obtain an interest rate in excess of the true average yield and the purpose of Section 125 was to allow the taxpayer to deduct the difference between the true average yield and the actual interest rate which was simply a return of capital, or premium. Again in terms of the case presented to this Court, it is patent that the 3% interest paid represented the yield of the bond and "true income to the taxpayer", and did not include or reflect any capital or premium. The excess payment as above noted, which was made in this case, was entirely unconnected with the interest of the bond. When once the legislative history is properly understood, it becomes apparent that this Court has approved a deduction which is wholly unwarranted by the statute and at variance with the legislative history. Moreover, it produces the garish result of permitting the taxpayer to recover out of interest something which has never been lost. Since the excess payment was made not for high interest but for stock options the taxpayer is ever in a position to recover the excess payment simply by converting the bonds and thus exercising the option. There is nothing for the taxpayer to recover from interest payments. Although this Court and the Tax Court recognized that premium "must be recovered tax free out of the earnings of the bond" (Op. p. 4), both courts ignored the basis of the deduction demonstrated by the legislative history.

2. It is respectfully submitted that this Court erred in concluding that the statute itself required the allowance of the deduction claimed by the taxpayer.[1] Even were it true that the statute contained an apparently unambiguous definition of "amortizable bond premium," the Court ought to have given effect to the actual purpose of Congress as demonstrated by the legislative history, especially since the deduction here claimed is wholly at variance with the legislative purpose. *United States* v. *Amer. Trucking Ass'ns*, 310 U. S. 53; *Harrison* v. *Northern Trust Co.*, 317 U. S. 476; *Mitchell* v. *Cohen*, 333 U. S. 411; *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Armstrong Co.* v. *Nu-Enamel Corp.*, 305 U. S. 315, 333.

[1] An analysis of the framework of the statute supports the Commissioner's position. As demonstrated, the purpose of the statute was to limit the payment of the tax to the true yield or true interest and allow for the recovery, by deduction, of the difference between the true yield and the actual rate of interest which is simply premium returned. For this reason Section 125 (a) (2) provides that there will be no deduction where no part of the purported interest is taxable. Where no part of the distribution is taxable there is no reason to allow for the deduction of that portion which is not true interest but is premium.

7 Section 125 (b) (1) does not contain a definition of "amortizable bond premium." It states only the method of computing the amount of the premium, which is by reference to the amount of the basis and the amount payable at maturity or on earlier call date. A statement of the method of computation of the amount of premium is not helpful to the Court in determining whether or not a payment is premium. If, for example, one of the paragraphs attached to an evidence of indebtedness provided that the holder, having paid $20 over and above the redemption price, would be entitled to purchase gold or silver, or indeed any other commodity or security at $20 below market price, it would be apparent that the excess payment was not bond premium but merely represented the price of what was in essence an option. Certainly Congress, in stating the method of computing the amount of bond premium did not intend to and did not in fact state that any amount paid in connection with a bond over and above the redemption price of the bond would be recoverable out of interest regardless of the nature or purpose of the payment and regardless of the fact that the payment was in no way reflected in the interest earnings.

3. A reading of the entire opinion of the Court reveals that the Commissioner was apparently not successful in presenting and explaining his position. The Court devoted a considerable portion of the opinion to demonstrating that the mere fact that a bond is callable or convertible does not remove it from the scope of Section 125. The Court also demonstrates that the bonds involved here are bonds within the meaning of the statute. The Commissioner is in full agreement with the Court in these respects. The question for decision however is whether the excess payments which the taxpayer seeks to deduct are "amortizable bond premium." The Court states in its opinion that in attempt-
8 ing to prove that the bonds do not involve "true bond premium," the Commissioner relies upon the precise wording of the applicable Treasury Regulations. This is an inaccurate statement of the Commissioner's position. The principal contention of the Commissioner is in no way dependent upon the language of the Treasury Regulations or specifically on the use of the phrase "on a date certain specified" as utilized in the Regulations. The Commissioner's position, as previously stated, is that, as a matter of common understanding, and furthermore, as demonstrated by the legislative history, "amortizable bond premium" represents the amount which has been originally paid to obtain a higher rate of interest and which is reflected in each interest payment as the difference between the average or true yield of the bond and the actual interest rate. It is not true that the Com-

missioner's position "requires the making of narrow and quite possibly unfair distinctions between varying bond issues" (Op. p. 7). The distinction is not between bond issues, but between those payments which are "amortizable bond premium" and those which are not. A convertible bond may be purchased at a price in excess of redemption value under circumstances that clearly indicate that the excess payment is truly bond premium and is reflected in and thus recoverable from interest earnings. This however is not the case here.

Wherefore the Commissioner respectfully prays that a rehearing of this proceeding be granted for the above mentioned reasons.

Respectfully submitted.

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
SUMNER M. REDSTONE,
Special Assistants to the Attorney General.

JUNE 1949.

9 *Certificate of Counsel*

The petitioner herein, by its attorneys, hereby certifies that the foregoing motion is not presented for the purpose of delay or vexation, but is, in the opinion of counsel well founded and proper to be filed herein.

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
SUMNER M. REDSTONE,
Special Assistants to the Attorney General.

JUNE 1949.

1743 United States Court of Appeals, for the Second Circuit

No. 202—October Term, 1948

(Petition filed June 22, 1949—Decided July 14, 1949)

Docket No. 21225

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

CHRISTIAN W. KORELL, RESPONDENT

Before: CHASE, CLARK, and DOBIE, *Circuit Judges.*

On petition for rehearing

THERON LAMAR CAUDLE, Asst. Atty. Gen., and Ellis N. Slack and Sumner M. Redstone, Sp. Assts. to the Atty, Gen., all of Washington, D. C., *for petitioner.*

PER CURIAM:

While we do not consider that we have misunderstood the Commissioner's position, at least to the extent asserted in his
1744 earnest and vigorous petition for a rehearing, yet it is desirable, against the event that the case may go higher, that his contentions before us be not misstated. Accordingly we set forth his position in his own words, viz, "that, as a matter of common understanding, and furthermore, as demonstrated by the legislative history, 'amortizable bond premium' represents the amount which has been originally paid to obtain a higher rate of interest and which is reflected in each interest payment as the difference between the average or true yield of the bond and the actual interest rate." This view that the quoted words have a single meaning so well understood that the statutory explanation can be considered only a method of computation and not a definition must necessarily control and limit the word "premium" itself. So the Commissioner says: "Bond premium is not any payment over the call price made in connection with the purchase of a bond regardless of the nature or purpose of the payment. It is not a payment manifestly made for an option to purchase stock as that here involved. Even were the legislative history unconvincing it could be demonstrated that as a matter of common understanding a bond premium represents the excess capital paid to obtain a higher rate of interest."

But this scholarly accountant's concept which is not so naturally a legal or a lay mandate, has not appealed to us, as it did not to the

several members of the Tax Court, 10 T. C. 1001, as being of universal significance. Nor did the legislative history—which was, in fact, cited in the Tax Court's decision and referred to by us—show so precise and exclusive a meaning ascribed to a fairly ordinary word. As a matter of fact, this restricted meaning of "premium" is definitely rejected in the law of trusts, and in the apportionment of principal and income to life tenant and remainderman, where the general idea of amortization has had perhaps its most
1745 extensive development in the law. Thus where amortization is required, a trustee is expected to restore to principal the excess amount he has expended, not some lesser theoretic amount resting on an unknown variable such as the assumed normal rate of interest on money. 1 Restatement, Trusts, § 239, comment f, 1935; 2 Scott on Trusts, § 239.2, 1939; 4 Bogert, Trusts and Trustees, § 831, 1935. Indeed from the time of Holmes on, the idea that the premium is paid solely for interest above the market rate has been attacked as clearly a fiction. *Hemenway* v. *Hemenway*, 134 Mass. 446, 449; *New England Trust Co.* v. *Eaton*, 140 Mass. 532, 544, 545, 4 N. E. 69 77, 78; 45 Yale L. J. 156; 20 Minn. L. Rev. 203; 34 Mich L. Rev. 448.[1] The passages quoted by the Commissioner seem to us no more than apt illustration and not at all a suggestion of exclusion of all else from the concept "premium," or of limitation of the broad statutory language. And the demonstration seems complete with the flat statement in the committee reports relied on by both the Tax Court and us—without the qualifying provisions surely natural if the Commissioner's projected limitations had been in the minds of the legislators—that "in the case of a convertible bond, if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section."

The petition for rehearing is denied.

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 14th day of July, one thousand nine hundred and forty-nine.

Present: Hon HARRIE B. CHASE, Hon. CHARLES E. CLARK, Hon. ARMISTEAD M. DOBIE, *Circuit Judges*.

---

[1] "That the premium is paid solely in respect of interest, which is the assumption supporting amortization, is a fiction, is demonstrated by any survey of bond prices." 45 Yale L. J. 156, 158, discussing *Old Colony Trust Co.* v. *Comstock*, 290 Mass. 377, 195 N. E. 389, 101 A. L. R. 1. The author of the annotation to this case, 101 A. L. R. 7, 9, has tried valiantly here and elsewhere (see 48 A. L. R. 682, 131 A. L. R. 1426) to argue that the problem in property law is only a simple mathematical and financial one, but without success with the courts. The uncertainties involved afforded one of the reasons for the rejection of a duty to amortize in the Uniform Principal and Income Act, § 6, 9 U. L. A. 593, 594, 599; *cf.* 1929 Handbk. Nat. Conf. of Commissioners on Uniform State Laws 290–293.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

A petition for a rehearing having been filed herein by counsel for the petitioner,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

ALEXANDER M. BELL,
Clerk.

United States Court of Appeals, Second Circuit

COMMISSIONER OF INTERNAL REVENUE

v.

CHRISTIAN W. KORELL

Order

United States Court of Appeals, Second Circuit. Filed July 14, 1949. Alexander M. Bell, Clerk.

United States of America, Southern District of New York

I, Alexander M. Bell, Clerk of the United States Court of Appeals for the Second Circuit, do hereby certify that the foregoing pages, numbered from 1 to 48, inclusive, contain a true and complete transcript of printed portions of the record and proceedings had in said Court, in the case of

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

as the same remain of record and on file in my office.

In testimony whereof, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, in the Second Circuit, this 28th day of September in the year of our Lord one thousand nine hundred and forty-nine, and of the Independence of the said United States the one hundred and seventy-fourth.

[SEAL]

ALEXANDER M. BELL,
Clerk.

U. S. GOVERNMENT PRINTING OFFICE: 1949

Supreme Court of the United States

No. 384, October Term, 1949

Order allowing certiorari

Filed December 5, 1949

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted. The case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Douglas took no part in the consideration or decision of this application.

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 384

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered June 8, 1949, rehearing denied, July 14, 1949, affirming the judgment of the Tax Court of the United States.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 9-14) are reported at 10 T. C. 1001. The initial opinion of the Court of Appeals (R. 17-21) and the opinion on rehearing (R. 31-2) have not yet been reported.

JURISDICTION

The judgment of the Court of Appeals was entered June 8, 1949. (R. 21.) A petition for rehearing was denied July 14, 1949. (R. 32-3.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

In August 1944, taxpayer purchased callable debenture bonds, of $100 face value, at slightly over $121; the bonds were then callable by the debtor at $104; they were also immediately convertible (at the holder's option) into the debtor's stock, which was selling at about $163, on surrender of $100 face value plus $40 in cash. On these facts, the Tax Court and the Court of Appeals recognized that the excess over the call price was not paid because of high interest returnable on the bonds but represented consideration paid for the valuable conversion option.

The question presented is whether the taxpayer is nevertheless entitled to an "amortizable bond premium" deduction from gross income for the taxable year 1944, measured by the difference between the cost of the bonds ($121) and the call price ($104).

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code and Treasury Regulations are printed in the Appendix, *infra*, pp. 12-21.

STATEMENT

The facts were stipulated (R. 2-9), and were found by the Tax Court as stipulated (R. 9-10):

The taxpayer, Christian W. Korell, is an individual residing in New York, New York, and having an office at 50 Broadway, New York, New York. During 1944, the taxpayer purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year, three per cent convertible debenture bonds, due September 1, 1956, as follows (R. 9):

Purchase Date	Face Value	Unit Price	Amount Paid
August 16, 1944	$11,000	at 121⅛	$13,351.25
August 16, 1944	2,000	at 121	2,425.00
August 22, 1944	37,000	at 121¼	44,862.50
Totals	$50,000		$60,638.75

The average price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share. (R. 9.)

The above bonds were issued under an indenture between the American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941.[1] Section 3.01 of the indenture (R. 4, 9-10) provided in part that on not less than thirty days' notice

[1] A copy of the indenture dated September 1, 1941, was attached as an exhibit to the stipulation of facts. Only the material provisions thereof are printed in the Record. The full indenture is being filed with the Court.

the bonds might be redeemed by the company in whole or in part on any date on or after September 1, 1942—

> at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter, 100%.

Section 4.01 of the indenture of September 1, 1941 (R. 4-5, 10), provided in part that the holder of any such bond—

> shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds), to convert * * * the principal of any such Debenture Bond * * * into such number of full-paid and non-assessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *

by the surrender of $100 principal amount of debenture bonds and payment to the company of

cash equal in amount to the excess of the conversion price over $100.

The entire issue of these bonds was called for payment under the provisions of the above indenture as of September 1, 1947, at 104, plus interest. (R. 10.)

The above American Telephone and Telegraph Company bonds purchased by the taxpayer were not part of the stock in trade of the taxpayer, or includible in any inventory of the taxpayer at the close of the taxable year; held by him primarily for sale to customers in the ordinary course of his trade or business, but they were purchased by him as an investment. The taxpayer did not, during the calender year 1944, sell any of the above bonds purchased by him, nor did he exercise his privilege of converting them into capital stock of the company. (R. 10.) In fact, the record fails to disclose what disposition was made of the bonds by the taxpayer. These American Telephone and Telegraph debentures were the only premium bonds purchased or owned by the taxpayer in the year 1944. (R. 10.)

In his federal income tax return for 1944, the taxpayer claimed as a deduction from gross income, in computing taxable net income, amortization of premium paid in connection with the above $50,000 face amount of bonds in the amount of $8,638.75, representing the difference between $60,638.75, the cost of the bonds, and $52,000, the call price of the bonds at 104, as set out in the inden-

ture of September 1, 1941.[2] (R. 10.) In determining the deficiency here involved, the Commissioner disallowed this deduction of $8,638.75, claimed by the taxpayer as amortizable bond premiums for the year 1944. (R. 3.)

The Tax Court held that this amount, representing the difference between the cost of the bonds involved and the call price thereof at earliest call date, constituted "bond premium" within the meaning of the applicable statutory provisions, and that it therefore was deductible in computing taxable net income for the year involved. (R. 10-14.) The Court of Appeals for the Second Circuit affirmed the decision of the Tax Court. (R. 17-21, 31-2.)

REASONS FOR GRANTING THE WRIT

1. The decision of the Court of Appeals for the Second Circuit in this case is in direct conflict with the later decision of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong,* decided September 9, 1949 (1949 P-H, Federal Tax Service, par. 72,593). Both cases involve the construction and application of Sections 23 (v) and 125 of the Internal Revenue Code, as amended (Appendix, *infra*), under substantially identical facts.

Sections 23 (v) and 125 were added as amend-

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[2] Taxpayer considered the call price of the bonds to be the price at which they could have been called if the debtor had given a call notice on the dates of purchase; under the indenture, this was 104. *Supra,* pp. 2-4. If taxpayer is entitled to the deduction, petitioner does not dispute this method of computation (R. 20).

ments to the Internal Revenue Code, effective for any taxable year beginning after December 31, 1941, by Section 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798. Section 23 (v) merely included among the authorized deductions from gross income the allowance for "amortizable bond premium" provided in Section 125. The latter section, in turn, defined "amortizable bond premium," fixed the amount allowable in any taxable year, prescribed the method of determination of the amount deductible, and made other and detailed provisions with respect to the allowance.

a. In this case, the taxpayer purchased in August 1944, $50,000 face amount of American Telephone and Telegraph Company 15-year, three per cent convertible debenture bonds at a cost of more than $121 per $100 face amount thereof. Under the governing trust indenture, these debentures were convertible at the time of purchase and until December 31, 1954, into capital stock of the Company at the rate of one debenture of $100 face amount plus $40 in cash for each share of stock. At the time of purchase, the capital stock of the Company into which the bonds could be converted was selling on the market for approximately $163 per share.[3] At that date, the debentures were callable, on thirty days' notice, at 104. In his income tax return for 1944, the taxpayer deducted, as "amortizable bond pre-

[3] It is to be noted that the market price of the stock ($163) was substantially equal to the market price of the bonds ($121) plus the sum to be paid in cash on conversion ($40).

mium", within the meaning of the above statutory provisions, the difference between the cost of these debentures and their call price on the earliest call date. The Commissioner disallowed the deduction.

The Tax Court found, in accord with a 1945 ruling of the Commissioner involving the same bond issue, that "in the present case, both the call price and the conversion figures indicate that the premium was paid, not for the investment feature of the bond, but for the rights of conversion." (R. 13.) The 1945 ruling of the Commissioner was based on a determination that this differential of more than $20 between the price and the $100 face amount of the bonds represented the market value of the conversion option rather than a premium paid for the investment value of the security itself.[4]

Despite this recognition that the amount involved did not represent premium paid for the investment value of the securities, the Tax Court held that the amount claimed was deductible as "amortizable bond premium" within the meaning of Sections 23 (v) and 125 of the Code. In its view, Congress intended to place all convertible bonds, with-

[4] The ruling is published in 1945 P-H, par. 76.157, and 1945 C.C.H., par. 6139, and is quoted from at length in footnote 15 of the Tax Court's opinion. (R. 12.) It states, in part, that "for nearly two years, the market price of those bonds has fluctuated almost directly in accordance with the quotations on the common stock into which such bonds are, at any time, convertible. This clearly indicates that substantially all of the so-called premium of $23.00 represents the market value of the conversion option, rather than a premium paid for the investment value of the security itself, considered independently of the conversion option" (R. 12). See fn. 3, *supra*, p. 7.

out exception, within the coverage of the deduction (R. 14). The Court of Appeals for the Second Circuit apparently agreed that the amount involved represented consideration paid for the conversion option contained in the bonds but likewise held that "even though the premium paid on them might well be due more to the privilege of conversion than to other features" the amount in question was deductible as amortizable bond premium. (R. 19.)

b. In *Commissioner* v. *Shoong* (C.A. 9), decided September 9, 1949, *supra,* the taxpayers, Joe Shoong and Rose Shoong, in June, 1944, each purchased $500,000 face amount of the same American Telephone and Telegraph Company 15-year, three per cent debentures, issued under this same trust indenture of September 1, 1941, at a cost in excess of $600,000, and in their income tax returns for 1944 each deducted, as amortizable bond premiums under Sections 23 (v) and 125 of the Internal Revenue Code, the difference between the cost of such bonds and the amount at which they were callable at the earliest call date. In reversing the Commissioner's disallowance of such deductions, the Tax Court, in an unreported Memorandum Findings of Fact and Opinion (dated June 14, 1948) (1948 P-H T. C. Memorandum Decisions, par. 48,095), merely followed its earlier decision in the instant case. The Commissioner's appeal in the *Shoong* case involved the same question as that in-

volved in his appeal in the present case. The Court of Appeals reversed the decision of the Tax Court and sustained the Commissioner's disallowance of the deductions, on the ground that the statute did not authorize a deduction for amounts paid in connection with the purchase of convertible debentures which actually represented consideration for the conversion option in the debentures, rather than a true investment premium. Congress intended the "amortizable bond premium" deduction to be allowed, the court held, only where the premium is in fact paid because the interest return on the bonds is higher than the average for comparable obligations. In its opinion, the Court of Appeals for the Ninth Circuit specifically disagreed with the "contrary conclusion" reached by the Court of Appeals for the Second Circuit in the instant case.[5]

2. The question here involved is also a question of general importance in the administration of the Revenue Acts which has not, but which should be, resolved by this Court. The issuance of debentures or other evidences of indebtedness permitting conversion, at the option of the holder, into stock of the issuing corporation is not unusual in corporate finance. Hence the question presented is one of general and continuing importance.

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[5] The opinion below notes the *Shoong* case as pending on appeal in the Ninth Circuit (R. 18).

CONCLUSION

For the foregoing reasons, it is submitted that the petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

OCTOBER, 1949.

APPENDIX

1. Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is ex-

cludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113 (b)(1)(H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and Partially Taxable Bonds.*—

(1) *Eligibility to elect and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25 (a) (1) or (2) is allowable; and

(B) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation

issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(26 U.S.C. 1946 ed., Sec. 125.)

2. Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125-1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a govern-

ment or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * *

SEC. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see sec-

tion 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117(h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * *

Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

SEC. 29.125-3. *Methods of Amortization.*— The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable

years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * *

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125-4. *Election.*—In the case of a corporation, the election provided in section

125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

SEC. 29.125-5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the tax-

payer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.

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No. 384

In the Supreme Court of the United States

OCTOBER TERM, 1949

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 384

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 9–14) are reported at 10 T. C. 1001. The opinion of the Court of Appeals (R. 16–21) is reported at 176 F. 2d 152.

JURISDICTION

The judgment of the Court of Appeals was entered June 8, 1949 (R. 21). A petition for rehearing was denied on July 14, 1949 (R. 33). The petition for a writ of certiorari was filed on October 11, 1949, and the writ was granted on December 5, 1949 (R. 34). The jurisdiction of this Court rests upon 28 U. S. C. Section 1254.

QUESTION PRESENTED

In August 1944, taxpayer purchased callable 3% debenture bonds, of $100 face value, at slightly over $121; the bonds were then callable by the debtor at $104; they were also immediately convertible (at the holder's ~~opinion~~ option) into the debtor's stock, which was selling at about $163, on surrender of $100 face value plus $40 in cash. On these facts, the Tax Court and the Court of Appeals recognized that the excess over the call price was not paid because of high interest returnable on the bonds but represented consideration paid for the valuable privilege of converting the bonds to the debtor's stock at a rate below the then market price of the stock.

The question presented is whether the taxpayer is nevertheless entitled, under Sections 23 (v) and 125 of the Internal Revenue Code, to an "amortizable bond premium" deduction from gross income for the taxable year 1944, measured by the difference between the cost of the bonds ($121) and the call price ($104).

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix, *infra*, pp. 31–39.

STATEMENT

The facts, as stipulated (R. 2–9) and as found (R. 9–10), may be summarized as follows:

Taxpayer, an individual, filed his income tax return for the period in question with the Col-

lector of Internal Revenue for the Second District of New York. (R. 9.)

During 1944 taxpayer purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3% convertible debenture bonds, due September 1, 1956, as follows (R. 9):

Purchase Date	Face Value		Unit Price	Amount Paid
August 16, 1944	$11,000	at	121¼	$13,351.25
August 16, 1944	$ 2,000	at	121	2,425.00
August 22, 1944	$37,000	at	121¼	44,862.50
Totals	$50,000			$60,638.75

The average market price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share. (R. 9.)

These bonds were issued under an indenture between American Telephone and Telegraph Company and City Bank Farmers Trust Company, trustee, dated September 1, 1941.[1] The indenture provided in part (Section 3.01 (R. 4)) that on not less than thirty days' notice the bonds might be redeemed by the company in whole or in part on any date on or after September 1, 1942, "at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for re-

[1] A copy of the indenture dated September 1, 1941, was attached as an exhibit to the stipulation of facts. Only the material provisions are printed in the Record. The full indenture has been filed with the Court.

demption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter, 100%." (R. 9–10.)

The indenture further provided (Section 4.01 (R. 4–5)) that the holder of any debenture bond "shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds), to convert * * * the principal of any such Debenture Bond * * * into such number of full-paid and nonassessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *," by the surrender of $100 principal amount of debenture bonds and payment to the company of cash equal in amount to the excess of the conversion price over $100. (R. 10.)

The entire issue of these bonds was called for payment under the provisions of the indenture as of September 1, 1947, at 104, plus interest. (R. 10.) The record does not indicate how and when

the bonds purchased by the taxpayer were disposed of.[2]

In his return for the taxable year (1944) taxpayer claimed as a deduction, in computing net income, "amortization" of the premium paid with respect to his bonds in the amount of $8,638.75, representing the full difference between $60,638.75—the cost of the bonds—and $52,000—the call price of the bonds, at 104. (R. 10.)[3]

The Commissioner disallowed the deduction, having ruled that the difference between the cost and the call price was not "amortizable bond premium," within the meaning of the statutory provisions. The Tax Court concluded that the Commissioner had erred and this conclusion was sustained by the Court of Appeals. (R. 9–15, 16–21.) Subsequent to the determination of the

[2] These American Telephone and Telegraph Company bonds purchased by the taxpayer were not part of his stock in trade, or includible in any inventory of the taxpayer at the close of the taxable year, held by him primarily for sale to customers in the ordinary course of his trade or business, but were purchased by him as an investment. The taxpayer did not, during the calendar year 1944, sell any of the above bonds purchased by him, nor did he exercise his privilege of converting them into capital stock of the company (R. 10). These debentures were the only premium bonds purchased or owned by him in the year 1944 (R. 10).

[3] Taxpayer considered the call price of the bonds to be the price at which they could have been called if the debtor had given a call notice on the dates of purchase; under the indenture, this was $104. *Supra*, pp. 3–4. If taxpayer is entitled to the deduction, petitioner does not dispute this method of computation (R. 20).

appellate court here, the Court of Appeals for the Ninth Circuit had occasion to consider precisely the same question—involving the same issue of A. T. and T. bonds—and reached a conclusion contrary to that reached in this case. *Commissioner* v. *Shoong*, 177 F. 2d 131 (pending on petition for a writ of certiorari, No. 453, this Term).

SPECIFICATION OF ERROR TO BE HELD

The Court of Appeals erred in holding that the difference between the cost and the call price of the debentures here was deductible in full in 1944 as "amortizable bond premium" within the meaning of the statutory provisions.

SUMMARY OF ARGUMENT

The legislative history of Section 125 of the Internal Revenue Code conclusively demonstrates that where the excess price over the call price of bonds or debentures is paid for the privilege of converting the debentures to capital stock at a rate below the market price of the stock, the difference between cost and call price is not "amortizable bond premium." The purpose of the Treasury in proposing the legislation, and of Congress in enacting it, was to provide for the amortization out of interest earnings of that portion of the interest which was in reality return of premium; and "amortizable bond premium" is that extra price which is paid to obtain an above-average interest yield and which is thus reflected in each interest distribution. Where a

true premium is paid, the value of the bonds will diminish by the mere passage of time, and Congress considered it sounder accounting practice to amortize out of interest earnings that part of the interest which was really premium, as a substitute for the prior procedure of taking a loss on disposition.

Here, no part of the so-called premium was paid to obtain a high interest rate; the interest was all true interest and did not reflect or include premium to any extent, and there was nothing to recover out of interest earnings. Moreover, since the taxpayer was in a position to recover the excess price paid by exercising the option to convert the bonds to stock, or simply by selling the bonds which reflected the conversion value, there was no loss to recover by amortization. In concluding that the difference between the cost and the call price of these debentures was nevertheless "amortizable bond premium," the Court of Appeals failed to give effect to the plain purpose of Congress in granting the deduction. The result was a conclusion wholly unwarranted by, and, indeed, squarely in the teeth of the legislative intention. The result is also a wholly gratuitous deduction, permitting the taxpayer to reap a windfall.

There is no support, moreover, for the court's decision in the statute's language. In Section 125, Congress did not establish a special definition of "amortizable bond premium," or equate

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it with every excess over call price or maturity value, and the meaning of the term must be gathered from the legislative purpose and aim, as well as from the common understanding of the words "bond premium."

ARGUMENT

The price paid in excess of the call price of the debentures involved was not "amortizable bond premium" within the meaning of sections 23 (v) and 125 of the Internal Revenue Code

Introductory

The single issue presented is whether the taxpayer is entitled, under Section 23 (v) and 125 of the Internal Revenue Code (Appendix, *infra*, pp. 31–34), to deduct in a lump sum as "amortizable bond premium" the full difference between the cost and the call price of certain 15-year 3% convertible debenture bonds of the American Telephone and Telegraph Company. The bonds were purchased in August of 1944 at the approximate price of $121 per bond, were callable at prices ranging from $104 to $100 depending on the call date,[4] and carried with them the privilege of conversion to the capital stock of the issuing company on the basis of one $100 bond plus $40 in cash for each share of capital stock. (R. 2–3, 9–10.) The average price of the capital stock at the time of the bond purchases was $163 a share. (R. 9.) The approximate sum of $17 per bond paid in excess of the actual call

[4] In August 1944, the call price was $104. *Supra*, p. 4.

price was thus plainly paid for the privilege of purchasing the stock at approximately $20 below the market price, rather than for the interest returnable on the bonds, and both the Tax Court and the Court of Appeals so recognized (R. 13, 18, 19). Nevertheless, each court held that the excess could be treated as "amortizable bond premium" under the provisions of Sections 23 (v) and 125, which were enacted into law in the Revenue Act of 1942, c. 619, 56 Stat. 798.

Basically, the question before the Court is whether this 1942 change in the Internal Revenue Code should be construed so as to permit the outright purchase of a tax deduction. While the Court of Appeals here concluded that Section 125 does embrace an apparently clear-cut tax windfall device, the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong*, 177 F. 2d 131, pending on petition for a writ of certiorari, No. 453, determined that the statutory provisions were not intended by Congress to be "construed as to produce this unreasonable result." The holding of the Court of Appeals for the Second Circuit to the effect that any amount paid in excess of the call price of convertible bonds is deductible under Section 125 as "amortizable bond premium" even though paid for the privilege of converting the bonds to stock at a rate below the market price of the stock, if permitted to stand, will constitute an open invitation to

taxpayers to shift income at will and to extinguish tax liability.

The nature of the legal problem and the workings of the tax scheme are perhaps best illustrated by reference to the parallel facts in the somewhat fuller record in *Commissioner* v. *Shoong, supra.* In June of 1944, Joe and Rose Shoong purchased over $1,000,000 worth of the same issue of A. T. and T. 15-year 3% convertible debenture bonds. Although each bond was callable at $104, the Shoongs also paid approximately $120 for each bond, for the same reason that the bonds carried with them the privilege of conversion to the capital stock of A. T. and T. at a rate of approximately $20 below the then price of the stock. Upon the purchase of the bonds, the taxpayers, like respondent here, claimed the entire difference between the cost and the call price of the bonds as an ordinary deduction under Sections 125 and 23 (v); the deduction was claimed in a single year since the bonds were callable after thirty-days' notice. The resulting deductions claimed by the Shoongs practically extinguished their 1944 income tax liability.[5] In accordance with

[5] Joe Shoong reported adjusted gross income of $104,304.58, and deductions of $97,533.76, of which $81,879.95 represented a claim for "amortization" of bond premium on the A. T. and T. bonds. The net income reported was $6,770.82 (No. 453, R. 21, 62).

Rose Shoong reported adjusted gross income of $100,927.43, and deductions of $96,235.34, of which $85,607.29 represented a claim for amortization of bond premium on the

their preconceived plan they held the bonds for slightly over six months and disposed of them in January of 1945, treating the difference between the adjusted basis and the selling price, which, of course, still reflected the conversion value, as capital gain—only half of which had to be taken into account for tax purposes.[6] *Shoong* v. *Commissioner, supra,* No. 453. (No. 453, R. 21–23, 30.) In short, the Shoongs purchased a tax windfall readily available to others on the open market by following a procedure considered by the Court of Appeals below to have been sanctified by Section 125.

In the Commissioner's view, the Second Circuit's determination "would permit the schemes of taxpayers to supersede the legislation in the determination of the time and manner of taxation." *Higgins* v. *Smith,* 308 U. S. 473, 477–478. Had the Court of Appeals devoted itself to the question as to "whether what was done, apart from the tax motive, was the thing which the statute intended" (*Gregory* v. *Helvering,* 293 U. S. 465, 469), giving proper effect to the legislative history, a contrary conclusion would have been

A. T. and T. bonds. The net income reported was $4,691.59 (No. 453, R. 22, 62).

[6] The adjusted basis took account of the 1944 deduction of amortizable bond premium. But the adjustment was reflected only to the extent of one-half in the computation of the Shoong's 1945 taxes, since it was taken into account only in the computation of capital gain on sale, whereas the 1944 deduction was measured by the full amount of the premium.

reached; for an analysis of the reasons leading to the enactment of the statutory provisions involved, and of their legislative history, conclusively demonstrates that the difference between the cost and the call price of these A. T. and T. debentures was not "amortizable bond premium."

A. *The legislative history and purpose of the Code provisions prove that only true bond premium can be amortized and deducted.*—In the 1942 amendment involved here, Congress did not permit the deduction or amortization of every excess over the call price or maturity value of a bond or debenture. As Congress was dealing with a "bond premium," that term does not encompass every payment over the call price or maturity value made in connection with the purchase of a bond, regardless of the purpose of the payment. Bond premium simply represents the excess capital paid by the purchaser in order to obtain a higher rate of interest than the current rate for comparable obligations. Neither in the mind of Congress nor in the common understanding of laymen is it a payment manifestly made for what is in essence a valuable option to purchase stock, or for some other privilege unrelated to the interest yield of the security.

That this was the meaning intended by Congress is undeniably proved by the Report of the House Ways and Means Committee (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 47 (1942–2 Cum. Bull. 372, 410) setting forth the reason for

the proposed deduction of "amortizable bond premium" as follows:

> Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance.
>
> The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. *Holders of taxable bonds not only pay a tax, as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital "lost" at maturity.* Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it. [Italics ours.]

This Committee Report indicates that, in the eyes of Congress, bond premium is that capital which has been paid to obtain a higher rate of interest than the average market yield, and which is thus included as a portion of each of the interest pay-

ments made on the bond. As the Report points out, prior to 1942 these interest payments were treated fully as income, amortization of the premium out of the interest earnings was not permitted, and the bondholder could take account of the premium, taxwise, only as a loss suffered at the time of call or of ultimate disposition of the obligation. See *New York Ins. Co.* v. *Edwards*, 271 U. S. 109, 116; O. D. 475, 2 Cum. Bull. 211; *Corn Exchange Bank* v. *Commissioner*, 6 B. T. A. 158. The purpose of the new deduction was to change this method of handling the premium, and to allow the taxpayer to recover out of the interest earnings that portion of the purported interest which was really capital or premium. In this connection, it is significant that in the *New York Ins. Co.* case the taxpayer made the following contention (pp. 112–113):

> Securities sell at a premium because they are sound and pay a high interest return. A part of the high interest return must be put aside each year to reimburse for the premium paid, that is, for the yearly loss of the premium. But the entire interest was taxed as income. Hence, if the part of the interest used to reimburse for the yearly loss of premium is deducted, then by the deduction only that part of the interest is taxed which was in fact interest income.

The rejection, under the then existing statute, of the contention made by the taxpayer there led

ultimately to the enactment of Section 125, which, as the Committee Report proves, incorporates into the law the concept that where a bond is issued at a true premium, the premium is paid to obtain a higher rate of interest, with the consequence that each interest distribution reflects in part a return of capital which should not be taxed as income.

That Congress used the term "amortizable bond premium" in this sense, and only in this sense, is further shown by the testimony of Randolph Paul, in his capacity as Tax Advisor to the Secretary of the Treasury, given before the House Ways and Means Committee. In explaining the nature of the deduction contemplated and the reason for granting it, Mr. Paul stated (1 House Hearings on the Revenue Act of 1942, p. 90):

> (d) *Amortization of bond premium.*—Holders of a tax-exempt security purchased at a premium are today in the unique position of being relieved of tax on the interest paid on the security and of receiving a deductible loss upon redemption or other disposition of the security to the extent of the premium. As *the premium at which a bond is obtained represents to the holder* merely an *effective yield lower than the actual interest rate*, the holder is entitled merely to tax exemption solely with respect to such effective yield. *The difference between the yield and the actual interest rate is simply a return of*

capital and should be treated as such rather than as a capital loss. On the other hand, the holder of a taxable security purchased at a premium is in the unfortunate position of being taxed upon the interest at high rates and of receiving a capital loss upon redemption whose deductibility is subject to the restrictions placed upon capital losses. *Since the yield rather than the actual interest rate reflects the true income to the taxpayer, only that income should be subject to tax and the capital loss should disappear.*

Proper tax treatment in both situations may be obtained through amortization of the premium. It is suggested that such amortization be mandatory for wholly tax-exempt securities and for partially tax-exempt securities held by a corporation. For all other securities the amortization should be at the taxpayer's election. [Italics supplied.]

As Mr. Paul points out, the premium represents the amount paid to obtain an interest rate in excess of the true average yield, and the purpose of Section 125 was to allow the taxpayer to deduct the difference between the true average yield and the actual interest rate, which was simply a return of capital, or premium.

The purpose of the deduction and the meaning of "amortizable bond premium" were also vividly explained by the testimony of John O'Brien of the Office of the Legislative Counsel before the

Senate Finance Committee. With regard to "amortizable bond premium" Mr. O'Brien testified as follows (1 Hearings Before the Committee on Finance, 77th Cong., 2d Sess., on H. R. 7378, p. 52):

> It deals with the case in which a bond is purchased, let us say, for $100 and upon redemption the taxpayer gets $90; or—Well, put it the other way: The bond is purchased for $110, and on redemption the taxpayer gets $100. That $10 is bond premium. Under the present law the amount of that $10 is treated as capital loss in the year in which the bond is redeemed. This proposes in the case of such a bond, the $10 of the bond premium shall be amortized over the life, the remaining life, of the bond. In the case, let us say, of a 10-year bond, the amortization would be $1 a year for 10 years.
>
> * * * * * *
>
> In the case of a bond the interest which is wholly or partially taxable, the amount of the amortizable bond premium for each year is allowed as a deduction and the basis of the bond is adjusted accordingly, so that when the bondholder at the end of the period redeems his bond, his basis will be down so that he has neither a capital gain nor capital loss.

Subsequently, Mr. O'Brien stated that the amortization sections were to be enacted (p. 53) "On the theory that the interest yield on the bond is

what he bargained for at 110, and he didn't bargain for a capital loss."

These legislative materials demonstrate that Congress' purpose in enacting section 125 was to substitute annual deductions by way of amortizing premium for the prior procedure of taking losses on the maturity or disposition of the bond. The basic premise of the new statutory provision was that the purchaser of a bond at a premium makes a capital expenditure and will in every case realize an ultimate loss. Prior to the enactment of Section 125 this loss was recognized in full at the time of disposition, and the holder was not permitted to recover the premium by deduction from the interest payments which were fully taxed as income. In other words, what the Treasury had in mind in proposing the legislation, and what Congress was concerned with in enacting it, was the situation where an individual might, for example, pay $110 for a $100 face value bond bearing a high interest rate, and callable at $100. Under such circumstances, on redemption the holder would receive $10 less than he paid for the bond;[1] and Congress—in recognition of the relationship between premium and the high interest rate (*supra*, pp. 12-18)—consid-

[1] Normally, the premium could not be wholly recovered by later sale of the obligation, since the value of the bond would decrease by the mere passage of time, as the call or maturity date approached and the premium (which depends upon the rate of interest and the period during which interest remains to be paid) diminished.

ered it sounder accounting practice to amortize the premium out of interest as a substitute for the prior procedure of taking a loss on disposition. But the necessary condition still remained that the capital expenditure which was to be recovered out of the interest earnings, through amortization, would otherwise be an inevitable loss. If the new yearly amortization deduction did not represent a portion of such a loss, it would be a pure windfall to the taxpayer, having the effect of granting a tax benefit for no valid purpose.

B. *The excess payment made by the taxpayer was not true bond premium, and he is not entitled to the deduction.* In upholding respondent's claim to an "amortizable bond premium" deduction, both of the lower courts ignored the basis for that deduction as revealed by the foregoing legislative history. The net effect of their determination is to permit the recovery of so-called "premium" out of interest (by way of the amortization deduction) although no premium was actually reflected in the interest payable on the bonds, to permit such recovery as a substitute for a nonexistent loss, and thus to sanction one of the most striking tax avoidance devices as yet propounded. For under the taxpayer's theory the excess is really not "amortizable" over the life of the bonds but is fully deductible in a single year where the bonds are callable at any time after notice, and six months later the bonds can be

sold at a long-term capital gain, the process being continuously repeated.[8]

1. In the first place, allowance of the deduction here is to run counter to the statute's aim to permit recovery out of interest payments of that portion of the payments which really represents the capital paid for a higher rate of return. In these cases, the 3% interest paid on the A. T. and T. bonds was the average rate of interest, and did not exceed the rate for comparable securities.[9] Accordingly, the interest payments would reflect only interest, and would include no premium or capital to be recovered; in Mr. Paul's phrase (*supra*, p. 16), the bonds' yield would be "true income to the taxpayer" and therefore fully subject to tax as income. Conversely, it is plain, as the courts below admitted (R. 13, 18–19), that the excess payment made by the purchaser was entirely unconnected with the interest paid on the bond. It was made for the privilege of converting the bonds to stock at below the then

[8] The record in this case does not show when or how the taxpayer disposed of the bonds in question, but the Tax Court's findings in the *Shoong* case, *supra*, show that debentures of the same issue were purchased on advice of counsel that the amount treated as bond premium could be deducted for income tax purposes and that after the bonds had been held a sufficient length of time so the gain could be reported as a capital gain they were resold. See *supra*, pp. 10–11.

[9] The *Shoong* record contains a stipulation, adopted by the Tax Court, showing, by reference to returns on comparable obligations, that the yield of the A. T. and T. debentures was not above average (No. 453, R. 27–28).

market price of the stock.[10] In short, the excess was not true bond premium; it was in no wise reflected or included in the interest rate or the interest distributions; and no reason exists to allow for the recovery out of interest of that which is not connected with, attributable to, or, in any way, reflected in the interest.

2. Still more important is that the interpretation of the Court of Appeals produces the extraordinary result of permitting the taxpayer to recover out of the bonds' interest something which has not been, and will not be, lost. As we have shown (*supra*, pp. 12–19), Congress did not intend to create, in Section 125, a special and gratuitous deduction unrelated to the taxpayer's expenditure of capital to obtain an above-average yield. The legislative purpose of the new deduction was to provide a substitute method for taking account of the fact that the amount of the premium is lost upon redemption of the bond. Previously, the bondholder could only treat this loss as a capital loss at the time of disposition or maturity; Section 125 permits the loss to be amortized and offset, as it were, against the annual interest payments. *Supra*, pp. 13–15, 18–19.

[10] See fn. 11, *infra*, p. 22. The *Shoong* findings also show that other public utility bonds of comparable investment desirability, but without comparable conversion rights, sold at a much smaller premium during this period. See No. 453, R. 26–27, 35.

But in this case there is no loss for the respondent to recover out of interest earnings. Assuming a static market, the taxpayer is always in a position to recover the excess price paid by converting the bonds into stock, or simply by selling the bonds which would continue to reflect the value of the conversion privilege." That is, respondent could at all times recover the full price he paid for the bonds (including the excess) either by exercising his option to pay an additional $40 and obtain A. T. and T. stock worth $163, or by selling the bonds at about the price he paid for them ($121). Unlike the case of the true bond premium with which Congress was

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[11] In 1945, the Commissioner found that over a substantial period of time the differential between the selling price and the call price of these A. T. and T. bonds had varied directly with the market price of the stock into which the bonds were convertible. The ruling is published in 1945 P-H, par. 76-157, and 1945 C. C. H., par. 6139, and is quoted from at length in footnote 15 of the Tax Court's opinion. (R. 12.) It states, in part, that "for nearly two years, the market price of those bonds has fluctuated almost directly in accordance with the quotations on the common stock in which such bonds are, at any time, convertible. This clearly indicates that substantially all of the so-called premium of $23.00 represents the market value of the conversion option, rather than a premium paid for the investment value of the security itself, considered independently of the conversion option" (R. 12).

The Tax Court's findings of fact in the *Shoong* case, No. 453, illustrate in detail the close relationship between changes in the value of the stock and changes in the bond prices. For about four years (1943–1947) the excess in the sale price of the stock over the sale price of the bonds was approximately $40—the additional cash required to convert the bonds into the stock. See No. 453, R. 24–25, 61.

dealing, the value of these bonds bearing the privilege to convert to capital stock at a "profit" approximately equal to the excess price would not decrease by the mere passage of time. The taxpayer is therefore always free to recover his outlay through conversion or sale—the bonds' yield is irrelevant to that recovery—and there is no reason or purpose in allowing him a deduction designed to cover the case of a bondholder who can only recover his excess payment out of the security's interest distributions. Of course, the market in fact is rarely static, but, as indicated in footnote 11, the fluctuation in the price of the bonds will vary directly with the price of the stock, and the amount which the bondholder can recover may be either more or less than his original outlay. The important thing, however, is that fluctuations in the amount recoverable are due to changes in the value of the option to convert and are in no way related to the passage of time as would be the situation in the case of true bond premium.

3. A very careful analysis of the legislative history and the rationale of the deduction set forth in Section 23 (v) and 125, in relation to the instant situation, was made by the Ninth Circuit in the *Shoong* case, No. 458, and the court there concluded that it was (177 F. 2d 131, 134; No. 453, R. 68):

> * * * obvious that the 1942 Act's embodiment of this accounting practice [of

> amortizing bond premium] is not applicable to the price above the principal of the bond attributable solely to a covenant to sell the company's stock at what may bring a profit to the purchaser.

And as the court stated, in reaching a conclusion contrary to that reached below (177 F. 2d, at 135; No. 453, R. 69–70):

> The cost of a bond above its maturity value because of a favorable interest rate was regarded as an amount expended to earn that interest, and sometimes recoverable as a capital loss. The deductions claimed in the instant case, however, represent no such expenditure to earn interest. The added amount over the maturity value of the bonds here represented the value of the stock purchasing right, which added amount had nothing to do with the call or redemption value of the bond. It earned the buyer nothing. It only brought him a stock speculation.

4. The purpose and history of the 1942 amendment thus affirmatively require that the claimed deduction be disallowed as outside the scope of the statute. Even if the matter was less clear, and the doubt greater, the balance would be swung by the established principle that deductions from gross income are matters of legislative grace, and the taxpayer bears the burden of showing that he falls squarely within the statutory class.

Deputy v. *du Pont*, 308 U. S. 488, 493; *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49.

C. The Court of Appeals for the Second Circuit erred in reading the statute and the legislative history. 1. The Second Circuit's brushing aside of the amendment's aim and history seems to rest largely on the view that Section 125 contains its own broad definition of "amortizable bond premium," which encompasses all excess payments over call price or maturity value. The court refers (R. 18) to Section 125 (b) (1) (Appendix, *infra*, p. 32) which provides that "the amount of bond premium * * * shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date * * *." But this provision does not contain a definition of "amortizable bond premium." As its wording indicates, it merely states the *method* of computing the amount of the premium, once it has been decided that an amortizable bond premium exists in the particular case. A statement of the method of computation of the amount of premium—assuming a real premium exists—is not helpful in the earlier step of deciding whether or not an excess payment is a true premium. Since Congress did not explicitly define "amortizable bond premium," the latter issue must be determined in accordance with the plain legislative purpose which we have set forth.

United States v. *Amer. Trucking Ass'ns,* 310 U. S. 534; *Harrison* v. *Northern Trust Co.,* 317 U. S. 476; *Mitchell* v. *Cohen,* 333 U. S. 411; *Gregory* v. *Helvering,* 293 U. S. 465; *Minnesota Tea Company* v. *Helvering,* 302 U. S. 609; *Armstrong Co.* v. *Nu-Enamel Corp.,* 305 U. S. 315, 333. Under this test, the excess payment made by respondent in this case cannot rightly be called a bond premium—any more than a bond premium would exist if one of the paragraphs attached to an evidence of indebtedness provided that the holder, having paid $20 over and above the redemption price, would be entitled to purchase gold or silver, or indeed any other commodity or security, at $20 below market price. In both instances, it is apparent that the excess payment is not bond premium but merely represents the price of what is in essence an option to buy gold or stock or some other property.

Certainly, Congress, in stating (in Section 125 (b) (1), *infra,* p. 32), the method of computing the amount of bond premium, did not intend to, and did not in fact, state that any amount paid in connection with a bond over and above the redemption price would be recoverable out of the bond interest (by way of this deduction), regardless of the nature or purpose of the excess payment, regardless of the fact that the payment was in no way reflected in the interest earnings, and regardless of the fact that the purchaser had

received value for the excess price entirely apart from the investment value of the bonds.[12]

2. The Second Circuit also relies on a supposed broader definition of bond premium in the law of trusts (R. 32). This reliance is particularly inappropriate in dealing with a tax statute directed to specific ends. In *Merchants L. & T. Co.* v. *Smietanka*, 255 U. S. 509, 521, which involved a determination as to whether the sale of corporate stock by testamentary trustees was income, this Court stated:

> The opinions of the courts in dealing with the rights of life tenants and remaindermen in gains derived from invested capital, especially in dividends paid by corporations, are of little value in determining such a question as we have here, influenced as such decisions are by the terms of the instruments creating the trusts involved and by the various rules adopted in the various jurisdictions for attaining results thought to be equitable.

[12] An analysis of the framework of the statute supports this position, and indicates the error in the Court of Appeals' reading of section 125 (b) (1). As we have shown, the purpose of the amendment was to limit the payment of the tax to the true yield or true interest and to allow for the recovery, by deduction, of the difference between the true yield and the actual rate of interest which is simply premium returned. For this reason, Section 125 (a) (2) provide that there will be no deduction where no part of the purported interest is taxable. Where no part of the distribution is taxable, there is no reason to allow for the deduction of that portion which is not true interest but is premium.

See also *United States* v. *Pelzer*, 312 U. S. 399, 402–403; *Morgan* v. *Commissioner*, 309 U. S. 78, 81.

Moreover, the general rule as to the trustee's duty to amortize, which the court cites (R. 32), does not show that a state court, faced with the striking situation presented here, would not require trustees to take account of the fact that the excess payment was plainly not true bond premium. And insofar as the court indicates its belief that a premium does not reflect a higher interest rate and that amortization should not be allowed (see R. 32, esp. fn. 1), the court was merely expressing a concept of premium deliberately repudiated by Congress in the 1942 amendment. It is significant, furthermore, that the very accounting theory as to the nature of premium, which we urge was embodied in the amendment, was propounded by the Government in *Old Colony Rd. Co.* v. *Commissioner*, 284 U. S. 552, 560–561. While the Court recognized the soundness of the theory, it concluded that Congress did not have that concept in mind in utilizing the common term "interest." Here, however, the legislative history overwhelmingly demonstrates that Congress did use the term "bond premium" in the sense for which we contend.

3. Nor is it true that the Commissioner's position "requires the making of narrow and quite possibly unfair distinctions between varying bond issues" (R. 20). The distinction is not between

bond issues, but between those extra payments which are bond premium and those which are not. A convertible bond may be purchased at a price in excess of redemption value under circumstances clearly indicating that the excess is truly bond premium and is reflected in, and thus recoverable from, interest earnings. This, however, is not the case here. As cases arise in which taxpayers claim payment of a true premium, the Tax Court, or other trier of facts, can decide in each instance whether the claim is valid or not. Decision in these cases will be no more difficult or complex than the numerous problems of fact and of apportionment which the Commissioner and the courts are daily called upon to make.

4. Finally, there is no substance in the reliance of the taxpayer, and of the courts below (R. 14, 19, 32), on a single sentence in the Committee Report, to the effect that convertible bonds are within the purview of Section 125 if the option to convert lies with the holder. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 80 (1942–2 Cum. Bull. 372, 433–434).[13] Since the overriding purpose of the statute is illustrated by the abundant legislative history (*supra*, pp. 12–18), it is manifest that this sentence indicates no more than that true premium paid for convertible bonds may be amortized where the option to convert

[13] The sentence reads: "In the case of a convertible bond, if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of the section." (R. 14).

is with the holder. It does not amount to a statement that any payment made in excess of the call price of a convertible bond is necessarily "amortizable bond premium", within the meaning of Section 125, simply because the option to convert lies with the holder. If there is a true premium, and if the holder has the option, then the bond "is within the purview of the section", and the Report does not purport to say any more than that.

CONCLUSION

The decision of the Court of Appeals for the Second Circuit is wrong and should be reversed.

Respectfully submitted,

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JANUARY 1950.

APPENDIX

1. Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allow-

able as a credit against net income, the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113 (b) (1) (H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and partially Taxable Bonds.*—

(1) *Eligibility to elect and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25 (a) (1) or (2) is allowable; and

(b) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the

partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(26 U. S. C. 1946 ed., Sec. 125.)

2. Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125–1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax),

whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * *

Sec. 29.125–2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of

the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125–5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * *

Amortizable bond premium on any bond to which section 125 applies in such part of the bond premium on the bond as is attributable to the taxable year.

Sec. 29.125–3. *Methods of Amortization.*—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first tax-

able year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * *

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125–2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) the amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125–4. *Election.*—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election

shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

SEC. 29.125–5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the

bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1949.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CHRISTIAN W. KORELL,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

Opinions Below.

The opinion of the Tax Court of the United States (R. 9-14) is reported in 10 T. C. 1001. The initial opinion of the Court of Appeals (R. 16-21) and the opinion on re-hearing (R. 31-32) have not yet been reported.

Jurisdiction.

The judgment of the Court of Appeals was entered June 8, 1949 (R. 21). A petition for re-hearing was denied July 14, 1949 (R. 32-33). The petition for a writ of certiorari was filed October 11, 1949. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

Question Presented.

Did the Tax Court and the Court of Appeals properly allow the deduction claimed by respondent in computing his net income for 1944 under Sections 23(v) and 125 of the Internal Revenue Code for amortization of the premium paid upon the purchase in that year of certain American Telephone and Telegraph Company 15-year, three percent convertible debenture bonds?

Statute and Regulations Involved.

The provisions of the Internal Revenue Code and Treasury Regulations involved are set forth in the Appendix, *infra*, page 5.

Statement.

The facts were stipulated in the Tax Court (R. 2-9) and the summarization thereof and the statement of the case contained in the petition for the writ (pp. 3-6) are not controverted.

Reasons for Denying the Writ.

(1) The Court of Appeals in affirming the unanimous decision of the Tax Court properly followed the plain language of the statute and correctly held that respondent was entitled to amortize the premium paid on the bonds here involved.

Section 125 of the Internal Revenue Code defines "bond premium" in precise and unambiguous terms. It sets forth with equal precision and clarity the method for determin-

ing the amount of bond premium "amortizable" in the taxable year.

In his 1944 return respondent deducted as "amortizable bond premium" an amount of $8,638.75, representing the difference between $60,638.75, the cost of the bonds and $52,000, the price at which the bonds were callable in 1944 (R. 3).

The Commissioner concedes that respondent correctly computed the amount of the premium in accordance with the statutory method. Nevertheless, he asserts that the amount so computed and amortized is not "true" bond premium (R. 19, 20, 30), and urges that the only premium entitled to amortization is that which represents an amount paid to obtain a higher rate of interest (R. 29).

The court below repudiated the Commissioner's contention as narrow and unfair (R. 20), resting its decision on the firm ground that to read any such narrow distinction into Section 125 would be "trespassing beyond the judicial, and upon the legislative, process" (R. 21).

(2) It is beyond question that the conflict between the decision in this case and that of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong*[1] is the result of the assumption by the latter court of powers reserved to the legislature in disregard of the rule that a court may not legislate by engrafting additions upon a statute to effect a purpose which does not appear on its face or from its legislative history.[2]

---

[1] Decided September 9, 1949 (1949 P-H Federal Tax Service, par. 72,593).

[2] *Matson Navigation Co.* v. *United States*, 284 U. S. 352, 356; *Corona Coal Co.* v. *United States*, 263 U. S. 537, 540.

See also:

United States v. *Cooper Corp.*, 312 U. S. 600, 605; *McClain* v. *Commissioner*, 311 U. S. 527, 530.

A conflict of this nature should not provide the occasion for a review of the decision of the Court of Appeals for the Second Circuit, which is plainly in accord with law.

(3) The entire issue of [redacted] involved herein has been called for payment under the provisions of the indenture (R. 3). Therefore, the question of whether it is proper to amortize the premium paid upon the purchase of these bonds is not of general and continuing importance.

Conclusion.

The petition for a writ of certiorari to review the decision of the Court of Appeals for the Second Circuit should be denied.

Dated: New York, N. Y., November 17, 1949.

Respectfully submitted,

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Appendix.

Internal Revenue Code:

SEC. 23 DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

• • • • • •

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

• • • • • •

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113(b) (1) (H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and Partially Taxable Bonds.*—

(1) *Eligibility to elect and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a) (1) or (2) is allowable; and

(B) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bonds.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (26 U. S. C. 1946 ed., Sec. 125).

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125-1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * * *

SEC. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the

period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * * * *

Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

SEC. 29.125-3. *Methods of Amortization.*—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition

or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125-4. *Election.*—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. • • •

SEC. 29.125-5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered

as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.

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SUPREME COURT, U.S.

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No. 384.

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CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1949.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CHRISTIAN W. KORELL,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

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OCTOBER TERM, 1949.

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COMMISSIONER OF INTERNAL REVENUE,
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v.

CHRISTIAN W. KORELL,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT.

Opinions Below.

The findings of fact and opinion of the Tax Court (R. 9-14) are reported in 10 T. C. 1001. The original opinion of the Court of Appeals (R. 16-21) and the *per curiam* opinion of the Court of Appeals on re-hearing (R. 31-32) are reported in 176 F. 2d 152.

Jurisdiction.

The judgment of the Court of Appeals was entered June 8, 1949 (R. 21). A petition for re-hearing was denied July 14, 1949 (R. 33). The petition for a writ of certiorari was filed on October 11, 1949, and the writ was granted on December 5, 1949 (R. 34). Jurisdiction is conferred on this Court by 28 U. S. C. Section 1254.

Question Presented.

The question presented is whether the Tax Court and the Court of Appeals correctly held that respondent was entitled, under Sections 23(v) and 125 of the Internal Revenue Code, to deduct from his 1944 gross income an amount of $8,638.75 as amortization of the premium paid upon the purchase in that year of certain convertible bonds of American Telephone and Telegraph Company.

Statute and Regulations Involved.

The provisions of the Internal Revenue Code and Treasury Regulations involved are set forth in the Appendix, *infra*, pp. 29-35.

Statement.

The facts as stipulated and as found by the Tax Court (R. 2-10) are briefly as follows:

Respondent, an individual, filed his income tax return for the period in question with the Collector of Internal Revenue for the Second District of New York (R. 9).

During 1944 respondent purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3 per cent convertible debenture bonds, due September 1, 1956, as follows (R. 9):

August 16, 1944	$11,000 at 121⅛	$13,351.25
August 16, 1944	2,000 at 121	2,425.00
August 22, 1944	37,000 at 121¼	44,862.50

The average market price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share (R. 9).

These bonds were issued under an indenture between American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941.[1] The indenture provided in part (Section 3.01 (R. 4)) that on not less than thirty days' notice the bonds might be redeemed by the Company in whole or in part on any date on or after September 1, 1942, "at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter 100%" (R. 9-10).

The indenture further provided (Section 4.01 (R. 4-5)) that the holder of any debenture bond "shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds) to convert * * * the principal of any such Debenture Bond * * * into such number of full-paid and non-assessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *," by the surrender of $100 principal amount of debenture bonds and payment to the Company of cash equal in amount to the excess of the conversion price over $100 (R. 10).

The entire issue of these bonds was called for payment under the provisions of the indenture as of September 1, 1947, at 104, plus interest (R. 10).

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[1] Only the material provisions of the indenture, an exhibit to and a part of the stipulation of facts (R. 3), are printed in the Record. The complete indenture has been filed with the Court.

These bonds were the only premium bonds purchased or owned by respondent in 1944. They were not part of the stock-in-trade of respondent or includible in any inventory of respondent at the close of the taxable year, or held by him primarily for sale to customers in the ordinary course of his trade or business, but were purchased by respondent as an investment (R. 10).

Respondent, in 1944, did not sell any of the bonds or exercise his right of converting them into capital stock of the Company (R. 10).

In his return for the taxable year (1944) respondent claimed as a deduction, in computing net income, amortization of the premium paid with respect to his bonds in the amount of $8,638.75 representing the difference between $60,638.75—the cost of the bonds—and $52,000—the call price of the bonds at 104 (R. 10).

The Commissioner disallowed the deduction of $8,638.75 and determined a deficiency. The Tax Court reversed the Commissioner and in a decision reviewed by the entire Court unanimously held (R. 9-15) that said amount of $8,638.75—the difference between the cost of the bonds and their earliest call price—was "amortizable bond premium" under Section 125 of the Internal Revenue Code and deductible from respondent's gross income under Section 23(v) of the Code. The Court of Appeals affirmed the decision of the Tax Court (R. 16-21) and denied the Commissioner's petition for re-hearing (R. 31-33). The Court of Appeals agreed that the excess of cost of the convertible bonds here in issue over their earliest call price was "amortizable bond premium" within the meaning of the statutory provisions (R. 16-21, 31-33).

Summary of Argument.

Section 125 of the Internal Revenue Code clearly and without ambiguity defines the term "bond premium" as the excess of the basis of a bond (in this case cost) over the amount payable on maturity or on earlier call date. This statutory definition, adopted by petitioner himself in his regulations, expresses the true intent of Congress as evidenced by the Committee Reports and the testimony of witnesses before the Congressional Committees. The definition of the term "bond premium" set forth in Section 125 to include any premium paid on the purchase of a bond without reference to one or another of the various factors which cause the premium to exist, is in accord with the common understanding of that term. There is no support either in the statute and its legislative history or in the common understanding of the term "bond premium" for petitioner's contention that only an amount paid to obtain a higher rate of interest is "true bond premium" subject to amortization. Neither is there any support for the corollary of that proposition—that where "true bond premium" exists the value of the bond will decrease as the call or maturity date approaches. The amount of bond premium determined in accordance with Section 125 of the Internal Revenue Code is "true bond premium" and is properly deductible under Section 23(v) of the Code.

In deducting in his 1944 income tax return as "amortizable bond premium" the amount of $8,638.75, representing the difference between the cost of the convertible bonds here involved and their earliest call price, respondent fully complied with the provisions of Section 23(v) and 125 of the Internal Revenue Code and the regulations thereunder.

Section 125 is applicable to bonds convertible into stock of the issuing corporation, as is plainly demonstrated by the broad language of the statute itself and its legislative history.

ARGUMENT.

POINT I.

The only issue presented is the meaning of the term "bond premium" as set forth in Section 125.

In 1944 respondent purchased as an investment $50,000 principal amount of American Telephone and Telegraph Company 15-year 3% Convertible Debenture Bonds due September 1, 1956 at a price of approximately 121% of par. At that time the bonds were subject to call at any time upon thirty days' notice at 104%. The bonds were also convertible at the option of the holder into stock of the company upon the surrender of $100 principal amount of a bond and the payment of $40 in cash in exchange for each share of stock. In his income tax return for 1944 respondent deducted, pursuant to Sections 23(v) and 125 of the Internal Revenue Code (Appendix, *infra*, pp. 29-31), as amortizable bond premuim the amount of $8,638.75 being the difference between the purchase price of the bonds and the then call price of 104%.

The petitioner concedes that if said amount of $8,638.75 is bond premium within the meaning of Section 125, the full amount thereof is deductible under Sections 23(v) and 125 as amortizable bond premium (Pet. Br., p. 5; R. 20, 29). However, because the bonds carried a conversion privilege petitioner seeks to deny the deduction on the ground that

the premium was not "true bond premium" within the meaning of the statute—that "true bond premium" is only that amount paid to obtain a higher rate of interest. The petitioner would here brush aside the plain language of the statute and of the Reports of the Congressional Committees which clearly show that Congress defined bond premium in broad terms as simply the difference between the cost of the bond and the amount payable at maturity or earlier call date. This statutory definition is not limited or restricted and in no way depends upon the presence or absence of any particular factor which may have caused the premium to exist. Petitioner would substitute for this clear statutory definition a vague, indefinite and elusive rule which would restrict the broad statutory definition and make it inoperative unless the premium were caused solely by the interest factor. He would have this Court disregard the mandatory statutory definition which correctly recognizes that many factors, in addition to the interest rate, influence the price of bonds and cause them to sell at a premium. Petitioner bases his entire argument upon an unsupportable assumption—that only a premium paid to obtain a higher rate of interest is "true bond premium" subject to amortization under Section 125.

The Tax Court in a decision reviewed by the entire Court (R. 10-14) rejected petitioner's contention for the reason that it conflicted with the plain statutory definition and ignored the interpretation which Congress itself placed upon the statute (R. 14). In affirming the Tax Court, the court below in its original opinion likewise declined to limit and restrict the term "bond premium" as urged by petitioner, and held that the statute provides a complete scheme applying in general terms to all forms of bonds, including callable and convertible bonds (R. 19). The

court below properly was of the opinion that to attempt to make the distinctions urged by petitioner in a statute so broadly worded would "be trespassing beyond the judicial, and upon the legislative, process" (R. 21).

Petitioner's contention that statutory "bond premium" represents only an amount paid to obtain a higher rate of interest was again rejected by the court below on rehearing as being unwarranted by the broad statutory language and at variance with its legislative history (R. 31-33).

The uncontested facts of this case (R. 2-3, 9-10) show that respondent has complied fully with all of the applicable provisions of the statute and regulations.

As evidenced by the conflict between the decision of the court below and the decision of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong*, 177 F. 2d 131 (pending on petition for a writ of certiorari, No. 453, this Term), the sole question presented to this Court is whether the clear statutory definition of the term "bond premium," as set forth in Section 125 of the Internal Revenue Code, is to prevail, or whether the characterization by petitioner of such premium as "true" or "not true" is to be the uncertain standard with which the taxpayer must comply at his peril. Therefore an affirmance herein does not require the Court to say that the statute "should be construed so as to permit the outright purchase of a tax deduction" (Pet. Br. p. 9), or to sanction a tax avoidance device (Pet. Br. p. 15).

POINT II.

The statute and the regulations clearly define the excess of the amount paid for the bonds here involved over call price as "bond premium". The statutory definition of "bond premium" expresses the Congressional intent.

Petitioner's contention that "bond premium" is not defined by the statute but represents only the amount paid to obtain a higher rate of interest (Pet. Br. pp. 12, 25) is squarely met by the statute itself which clearly prescribes the method of determining the existence and amount of bond premium and the amortizable amount thereof which is deductible in the taxable year. It is not necessary to look beyond the four corners of the statute which "still remains the best indicator of the legislative intent" (R. 18) to determine what is bond premium which is subject to amortization.

It is well settled that the intention of Congress is to be sought primarily in the language used and that where the statutory language is clear and unambiguous there is no room for construction.

Helvering v. *City Bank Farmers Trust Co.*, 296 U. S. 85, 89;
Osaka Shosen Kaisha Line v. *U. S.*, 300 U. S. 98, 101;
Thompson v. *U. S.*, 246 U. S. 547, 551;
Caminetti v. *U. S.*, 242 U. S. 470, 485;
Packard Co. v. *Labor Board*, 330 U. S. 485, 492;
United States v. *Rice*, 327 U. S. 742, 753.

See also:

Forrestal v. *Commissioner* (2nd Cir.), 120 Fed. (2d) 223, 225.

The scheme of Section 125 is remarkably simple and concise although wholly complete. It states in unequivocal terms that

> "* * * *the amount of bond premium*, in the case of the holder of any bond, *shall* be determined with reference to the amount of the basis * * * of such bond, and with reference to the amount payable on maturity or on earlier call date, * * *." (Subsection (b)(1), Appendix, *infra*, p. 30.) (Italics supplied.)

and that

> "The amortizable bond premium of the taxable year *shall* be the amount of the *bond premium* attributable to such year." (Subsection (b)(2), Appendix, *infra*, p. 30.) (Italics supplied.)

Hence, the amount of the bond premium in this case is determined by reference to the amount of the basis of the bonds (cost $60,638.75) and with reference to the amount payable on the earlier call date ($52,000). The amortizable bond premium of the taxable year (1944) was the amount of the bond premium attributable to such year. Since the earliest call date occurred in 1944, the year of purchase, the amount attributable to that year was the entire bond premium of $8,638.75. This method of computation is not disputed by petitioner. (Pet. Br. p. 5; R. 20, 29.)

The language of subsection (b)(1) is mandatory and provides only two guideposts for determining the amount of bond premium—the cost of the bond and the amount payable at maturity or earlier call date. In accordance with the plain language of subsection (b)(1) of Section 125, bond premium is simply the difference between the cost of the bond and the amount payable on maturity or on earlier call date. At the time of the enactment of Section 125 the petitioner entertained none of the doubts

which now beset him that this statutory definition of bond premium is correct and fully expressive of the intent of Congress. In his own regulations the Commissioner (§29.125-2, Regulations 111; Appendix, *infra;* p. 33) defined "bond premium" in exact conformity with the statute as follows:

> "Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date."

The above provision of the regulations, which was relied upon by respondent in computing the deduction for amortizable bond premium is still in full force and effect and has not been modified in any respect by the petitioner. The regulations contain none of the qualifications or restrictions that petitioner now urges nor, as pointed out by the Court below, "does petitioner suggest any definition of his concept of sufficient precision so that it could safely be relied on by taxpayers or revenue enforcing authorities hereafter" (R. 20).

In this case, the bonds were subject to call during the taxable year. Therefore the entire amount of bond premium was attributable to the taxable year 1944 and was properly deducted by respondent in his income tax return for that year. The correctness of this computation is conceded by petitioner (Pet. Br., p. 5; R. 20, 29).

That the statutory definition of "bond premium" as the difference between the cost of the bond and the amount payable at maturity or earlier call date—without regard or reference to the various factors which may have caused the premium—expresses clearly and without ambiguity the intent of Congress is undeniable. This is demonstrated by

the Reports of the House Ways and Means and Senate Finance Committees accompanying the Revenue Act of 1942 wherein it is said:

> "The terms 'bond premium' and 'amortizable bond premium,' as used in this section, refer to different amounts. Bond premium, in the case of any bond subject to this section, is the total premium thereon; that is, the excess of the basis of the bond for determining loss over the amount payable at maturity. On the other hand, amortizable bond premium is such part of the total premium on the bond as is attributable to the taxable year.
>
> "H. Rep. No. 2333, 77th Cong., 2nd Sess., p. 79 (1942-2 CB 372, 432); S. Rep. No. 1631, 77th Cong., 2nd Sess., p. 93 (1942-2 CB 504, 574-575)."[2]

Congress could have used no plainer words to express its intent than those contained in the foregoing statement. Moreover, the Committee Reports make it perfectly clear, as above stated, that "amortizable bond premium" under subsection (b)(2) of Section 125 is merely an amount computed by reference to the total "bond premium" determind in accordance with subsection (b) (1) thereof. The Committee Reports in referring to callable and convertible bonds further state that "the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date."[3] Therefore there is no validity to petitioner's assertion (Pet. Br., pp. 25-26) that subsection (b)(1) "merely states the *method* of computing the amount of the premium" rather than a definition of "bond premium".

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[2] Petitioner fails to cite or refer to this portion of the Committee Reports in his brief.

[3] *Infra*, p. 26.

The above statement of legislative intent embodied in the Committee Reports, the clear and unequivocal language of the statute itself, and the equally clear provisions of the Commissioner's regulations leave no uncertainty that bond premium for the purposes of Section 125 is simply the difference between the cost of the bond and the amount payable at maturity or earlier call date. Here the plain words of the statute are in no danger of being overcome "by a legislative history which, through strained processes of deduction from events of wholly ambiguous significance, may furnish dubious bases for inference in every direction." (*Gemsco, Inc.* v. *Walling*, 324 U. S. 244, 260). Rather, the legislative history of Section 125 serves quite the opposite function of strengthening the ordinary meaning of the statutory language.

In addition to the plain language of the statute itself, the Commissioner's own regulations, and the statements contained in the Committee Reports, there is ample evidence in the testimony of witnesses appearing before Congressional Committees that Congress, with full awareness, intended that the term "bond premium" for purposes of Section 125 should be the difference between cost and the amount payable on maturity or earlier call date regardless of whether the premium is caused in whole or in part by a conversion privilege. Nothing in the statute, the regulations, the Committee Reports, or the testimony of witnesses at Committee hearings on the Revenue Act of 1942 lends any support to the proposition that the term "bond premium" is limited to an indefinite sum representing a theoretical calculation of the amount paid to obtain a higher rate of interest.

From the testimony of Mr. Roy C. Osgood, Vice-President of the First National Bank of Chicago, in charge of its Trust Department, it is apparent that Congress was fully

apprised that in the case of callable and convertible bonds the premium might be the result of the conversion privilege. (Vol. 3 Hearings Before House Ways and Means Committee, 77th Cong., 2d Sess. on Revenue Revision of 1942, pp. 2826-7; Vol. 2 Hearings Before Committee or Finance, U. S. Senate, 77th Cong., 2d Sess. on H. R. 7378, pp. 1723-4, 1728-9).

Mr. Osgood was opposing the enactment of Section 125 because in his opinion the passage of the section would create difficulties in trust administration. His testimony names various bond issues, including issues of callable bonds and one issue of bonds both callable and convertible, all of which are cited as typical examples and not as isolated cases. To illustrate his point, Mr. Osgood cited before the Senate Finance Committee the issue of Commonwealth Edison Convertible Debentures, 3½'s, due July 1, 1958, callable at any time at 102¾ upon thirty days' notice. Pointing out that these bonds were then quoted at 110, the witness, at page 1729, raised the following questions:

> "Does the purchaser amortize the premium over call of 7¼ points within 30 days after purchase and do likewise in the case of innumerable other bonds selling above call which are also redeemable any time on 30 days' notice?
>
> "Suppose the purchaser of Commonwealth Edison 3½'s immediately writes his cost down to 102¾, and *on account of the conversion feature* within a reasonable time the bond duplicates the price of 131 at which it sold in 1940. If he sells at that price must he pay a tax on his theoretical profit of 28¼ points or on his actual profit of 21 points?" (Italics supplied).

This testimony makes it clear that Congress in enacting Section 125 was fully aware of the existence of numerous bonds which are both callable and convertible, and that the

conversion privilege might well cause fluctuations in the selling prices of bonds and be a factor in determining the amount of the premium. This testimony also brought out very clearly that in the event of a sale of the Commonwealth Edison bonds referred to therein at a price in excess of the call price of 102¾ (the original cost of 110 reduced by the deduction for amortization) a capital gain would be realized which would, at least in part, have resulted from the amortization deduction. In the example given by Mr. Osgood the capital gain would have been 28¼ points and this would have included the entire amortizable bond premium of 7¼ points.[4] If the bonds had been held for more than six months only one-half of this gain of 28¼ points would be taken into account for tax purposes pursuant to the provisions of Section 117(b) of the Internal Revenue Code (footnote 7, *infra*, p. 24).

The very situation which petitioner characterizes as "one of the most striking tax avoidance devices as yet propounded" (Pet. Br., p. 19) and "an apparently clear-cut tax windfall device" (Pet. Br., p. 9) was plainly disclosed to the Senate Finance Committee at the hearings on the Revenue Act of 1942. The interrelation of the various sections of the Internal Revenue Code was certainly well known to the Congressional Committees and the Treasury experts and it cannot be said that they were not cognizant of the fact that a deduction for amortizable bond premium might in the case of a later sale of the bond become a taxable capital gain subject to the percentage limitations provided by Section 117 of the Internal Revenue Code. Nonetheless, in defining "bond premium" in Sec-

[4] In accordance with the provisions of Section 125(a) (3) (Appendix, *infra*, pp. 29, 30) of the Internal Revenue Code the cost of the bonds in the above example is required to be reduced pursuant to the provisions of Section 113 (b) (1) (H) of the Internal Revenue Code (footnote 6, *infra*, p. 23).

tion 125(b)(1) and in the Committee Reports, Congress did not in any way attempt to limit or restrict the definition to exclude a premium resulting from a conversion privilege or any other particular value-creating factor. Instead, Congress clearly stated that bond premium for which an amortization deduction is allowable is in all cases the excess of the cost of the bond over the amount payable at maturity or earlier call date.

The testimony of Mr. Randolph Paul, Tax Advisor to the Secretary of the Treasury (Pet. Br., p. 15; R. 27-28) and the portion of the Committee Reports quoted by petitioner (Pet. Br., p. 13) are not pertinent to the issue herein and give no support to the contention that the "bond premium" for which a deduction was provided is only the amount paid to obtain a higher rate of interest. Mr. Paul's statement is not addressed to the meaning of the term "bond premium," nor does it refer to the various factors which might cause a bond to sell at a premium. It simply states that where a premium is paid, the purchaser realizes an effective yield less than the actual interest rate and that the difference between yield and interest rate is a return of capital; that "yield rather than the actual interest rate reflects the true income to the taxpayer." Since the "yield" can only be determined by reference to the amortization period and the amount of the premium paid, it is apparent that Mr. Paul's statement assumed the existence of a premium and a definite amortization period and that it was, therefore, unnecessary for him to consider the various factors causing a bond premium. Nowhere in his statement does Mr. Paul indicate that he had in mind any definition of "bond premium" other than that clearly set forth in the statute and the Committee Reports.

The portion of the report of the Ways and Means Committee quoted by petitioner (Pet. Br., p. 13) likewise does

not support petitioner's contention and contains nothing which would limit the broad statutory definition of bond premium simply to that amount paid to obtain a higher rate of interest.

The testimony before the Senate Finance Committee of Mr. John O'Brien of the Office of the Legislative Counsel, to which petitioner refers (Pet. Br., pp. 16-18), fully supports respondent's view that "'bond premium" is simply the difference between cost and the amount payable at maturity or earlier call date. At one portion of his testimony Mr. O'Brien recites the case of a bond purchased for $110 on which the taxpayer gets $100 on redemption, and concludes that "That $10 is bond premium." The balance of the testimony of this witness quoted in petitioner's brief, if at all relevant to the within issue, does not support the contention urged by petitioner.

POINT III.

The statutory definition of bond premium is in accord with the generally accepted meaning of that term.

In urging that bond premium is only that amount paid to secure a higher rate of interest, the petitioner is asking this Court to adopt a narrow and restricted definition of that term which not only conflicts with the plain language of the statute and its legislative history, but is at variance with the generally accepted meaning of that term.

The court below pointed out that "this restricted meaning of 'premium' is definitely rejected in the law of trusts • • • where the general idea of amortization has had perhaps its most extensive development in the law. Thus where amortization is required, a trustee is expected to

restore to principal the excess amount he has expended, not some lesser theoretic amount resting on an unknown variable such as the assumed normal rate of interest on money. 1 Restatement, Trusts, §239, comment f, 1935; 2 Scott on Trusts, §239.2, 1939; 4 Bogert, Trusts and Trustees, §831, 1935" (R. 32).

The court further said that: "from the time of Holmes on, the idea that the premium is paid solely for interest above the market rate has been attacked as clearly a fiction. *Hemenway* v. *Hemenway*, 134 Mass. 446, 449; *New England Trust Co.* v. *Eaton*, 140 Mass. 532, 544, 545; 4 N. E. 69, 77, 78; 45 *Yale L. J.* 156; 20 *Minn. L. Rev.* 203; 34 *Mich. L. Rev.* 448" (R. 32).

In common understanding the term "bond premium" is the excess of the purchase price over the amount payable at maturity or earlier call date.

"When bonds sell at a price greater than par, they are said to sell at a premium . . ." J. I. Bogen, Editor, Financial Handbook, 3rd Ed., The Ronald Press Company, New York, 1948, p. 1210. Also in Grossman, Investment Principles and Practice, Longman's Green & Co., New York, 1939, it is said at page 14: "Very frequently bonds sell in the market at a price in excess of the face value or at a *premium*." (Italics supplied).

See also:

Montgomery's Federal Taxes—Estates, Trusts and Gifts—The Ronald Press Company, New York, 1949-50, p. 148;

Chamberlain & Edwards, The Principles of Bond Investment—Revised and Enlarged Edition, 1927, p. 75;

Prime, Investment Analysis, p. 107—Prentice-Hall, 1946.

It may be assumed that Congress used the words "bond premium" in Section 125 to express their usual and ordinary meaning.

Crane v. *Commissioner*, 331 U. S. 1, 6;
United States v. *Warts*, 303 U. S. 414, 417;
Woolford Realty Co. v. *Rose*, 286 U. S. 319, 327.

It is also commonly understood and generally accepted that while the interest factor, namely the condition of the money market, is an element that influences bond prices, it is by no means the sole factor. Other factors which enter into the placing of a premium on a bond are (a) the credit standing of the issuing company; (b) the security of the bond issue; (c) the maturity of the bond; (d) whether such bonds are convertible or callable; and (e) the redemption price. See J. I. Bogen, Editor, Financial Handbook, 3rd Ed., The Ronald Press Company, New York, 1948, p. 1211. In 4 Bogert, Trusts and Trustees, cited above, the author says in §831:

> "* * * It can be said with much force that many factors enter into the placing of a premium on a bond. The interest rate of the bond in question, the general money market, the maturity of the bond, features of advantage aside from interest (such as convertibility), security of payment of interest and principal, marketability, etc., all may cause a premium to be paid on a bond in some cases. * * *. It is impossible to separate out the amount of premium paid for this element of advantage or that."

The assertion of petitioner that the premium on any bond depends solely upon the rate of interest (Pet. Br., p. 16) and the corollary of that proposition (Pet. Br., p. 18) that "the value of the bond would decrease by the

mere passage of time, as the call or maturity date approached and the premium (which depends upon the rate of interest and the period during which the interest remains to be paid) "diminished" are readily disproved. Were interest the sole factor then, as urged by petitioner, the premium would decrease with mathematical exactitude and regularity as the maturity or call date of the bond approached. But reference to the behavior of bonds in the open market, even where the bonds carry no conversion privilege and are not immediately callable, discloses that prices may actually increase, rather than decrease, as the maturity date approached.

For example, the following bonds, all of which were non-convertible and not currently callable, fluctuated in price during the 10-year period 1935 to 1944 and actually increased in price as the maturity date approached,

	High	Low
Bell Telephone of Pennsylvania 5's, C, 1960 (Callable at par on October 1, 1957)	137¼ (1941)	116¾ (1935)
Capital Traction Company 1st 5's, 1947	110 (1944)	61 (1938)
Texas Power & Light Company Deb. 6's, 2022 (Callable at 110 on July 1, 1947)	121¾ (1940)	83½ (1935)

Would petitioner say that a purchaser of the non-callable and non-convertible Bell Telephone bonds in 1941, who paid a price 37¼ points above par, did not pay a "true bond premium" because the price of the bonds did not diminish as

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[5] Moody's Public Utilities, 1945, Special Features Section, pp. a 62 et seq.

the maturity date approached? Yet that is exactly what petitioner says in this case when he urges the Court to hold that "true bond premium" is only that premium which is paid to obtain a higher rate of interest, and which premium diminishes with the mere passage of time.

This Court itself has recognized that factors other than interest may determine prices at which bonds are sold and that bond prices do not necessarily decline as the maturity date approaches. In *New York Life Insurance Co. v. Edwards*, 271 U. S. 109, decided prior to the Revenue Act of 1942, the Court disallowed a deduction for amortization of bonds purchased at prices above par, but pointed out at page 116 that "All of the securities might have been sold thereafter above cost."

POINT IV.

Respondent has complied fully with all the applicable provisions of the statute and regulations and is entitled to the deduction.

Petitioner concedes that the American Telephone and Telegraph Company bonds are "bonds" within the meaning of the statute (R. 29). Furthermore, the uncontested facts of this case (R. 2-3, 9-10) demonstrate respondent's complete compliance with the statutory requirements.

Subsection (a) (1) of Section 125 requires that bond interest be fully taxable.

Interest on the American Telephone and Telegraph bonds was fully taxable and the requirement of this subsection was satisfied.

Subsection (b) (1) requires that in determining the bond premium, the holder of *any* bond must use the basis (for determining loss on sale or exchange)

of such bond and the amount payable at the maturity or earlier call date.

Meeting this requirement, the respondent used the difference between the purchase price of $60,638.75 (his basis for determining loss) and the earliest call date price of $52,000, as the bond premium.

Subsection (b) (2) defines *amortizable* bond premium as the amount of the premium attributable to the taxable year.

The respondent purchased all of his bonds in 1944, and the earliest call date was also in 1944. The entire premium was therefore amortizable in the taxable year 1944.

Subsection (b) (3) provides that one method of computing amortizable bond premium is the method prescribed by the Commissioner.

The respondent followed the method prescribed by Section 29.125-5 of Regulations 111.

Subsection (c) (2) requires that a taxpayer who elects to amortize bond premium must be consistent in that he must amortize the premium on all bonds purchased at a premium and owned during the taxable year.

Respondent purchased or owned in 1944 only the American Telephone and Telegraph bonds, and amortized the bond premium on *all* such bonds.

Subsection (d) in effect excludes security dealers and traders from computing bond premium amortization under Section 125 on bonds held as stock in trade.

Respondent was not during the taxable year 1944 a dealer or trader in securities, but purchased the aforesaid bonds as an investment.

Under the law applicable to this case there can be no speculation as to whether bond premium is "true", "false"

or "quasi"; it can only be "statutory" bond premium. Respondent deducted the "statutory" bond premium in his 1944 return as he was permitted to do by Section 23(v) of the Internal Revenue Code.

This deduction is allowable without reference to the receipt by a taxpayer of gross interest earnings on bonds. If bonds become in default and the taxpayer receives no interest in the taxable year, nevertheless, having elected to amortize bond premium with respect to such bonds, he would be entitled to the deduction provided by statute. (Section 125(c) (2), Appendix, *infra*, p. 31).

Once an election to amortize is made it is mandatory thereafter to continue the deduction for amortization regardless of any resulting tax benefit or detriment to the taxpayer. For example, if a taxpayer has no income during the taxable year, the deduction for amortizable bond premium will produce no tax benefit. Nevertheless, under Section 113(b) (1) (H) of the Internal Revenue Code[6] the basis of his bonds would have to be reduced by the amount of such deduction. In the event of a later sale of the bonds this reduction in basis would increase the amount of gain (or decrease the loss) realized upon such sale. While,

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[6] "Sec. 113. * * *

"(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made.

* * * * * * *

"(H) in the case of any bond (as defined in section 125) the interest on which is wholly exempt from the tax imposed by this chapter, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 125 (a) (2), and in the case of any other bond (as defined in such section) to the extent of the deductions allowable pursuant to section 125(a)(1) with respect thereto."

under Section 117(b) of the Internal Revenue Code[7] only one-half of any gain on such sale would be recognized for tax purposes if the bond had been held for more than six months, this result is no different than in the case of an individual who realizes a profit on the sale of depreciable business property held for more than six months. (Section 117(j) of the Internal Revenue Code.)[8] In the latter case, just as in the case of the sale of the bonds, only one-half of the gain would be subject to tax despite the fact that the entire gain might result solely from a reduction in basis required to be made because of amounts previously allowed as deductions from ordinary income for depreciation.

The respondent has fully complied with the statutory provisions and is, therefore, entitled to the benefit of the deduction permitted by Sections 23(v) and 125 of the Internal Revenue Code.

White v. *U. S.*, 305 U. S. 281, 292;
New Colonial Ice Co. v. *Helvering*, 292 U. S. 435, 440.

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[7] "Sec. 117 • • •

"(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months."

[8] Sec. 117

"(j) • • •

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business • • • held for more than 6 months • • • exceed the recognized losses from such sales, exchanges, • • • such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months • • •"

Even if the record in this case should show, which it does not, that respondent was motivated by a tax saving purpose, he is nonetheless entitled to the full benefits permitted by the law.

U. S. v. *Cumberland Public Service Company* (United States Supreme Court, No. 214—October Term 1949, decided January 9, 1950).

Section 125 sets forth a simple rule for determining the existence and amount of bond premium and the amortizable portion thereof. The application of this rule does not require any finding or determination as to the various factors which might cause bonds to sell at a premium. Congress thereby made it unnecessary to resort to "narrow and quite possibly unfair distinctions between varying bond issues" (R. 20). In so doing Congress wisely avoided the difficulties that would have been inherent in the administration of a statute which attempted to incorporate petitioner's concept of "true bond premium" with "sufficient precision so that it could safely be relied on by taxpayers or revenue enforcing authorities" (R. 20).

The words of the statute here involved are plain and unambiguous. Under such circumstances, a court is not at liberty to add to or to alter them to effect a purpose which does not appear on its face or which varies from its legislative history.

Matson Navigation Co. v. *U. S.*, 284 U. S. 352, 356;
Corona Coal Co. v. *U. S.*, 263 U. S. 537, 540.

POINT V.

The convertible bonds here involved are within the purview of Section 125 of the Internal Revenue Code.

The petitioner concedes that convertible bonds are within the scope of Section 125 (R. 29).[9] Nevertheless he takes the position that with respect to the convertible bonds here involved the statute does not apply for the same reason as urged elsewhere throughout his brief for the disallowance of the amortization deduction, viz., that the premium paid was not "true bond premium" (Pet. Br., p. 29).

As is plainly demonstrated by the preceding analysis of the statutory provisions involved, Congress did not require as a condition of premium amortization that the premium must result from some particular value creating factor, but instead provided simply that the amount of bond premium is the difference between cost and the amount payable at maturity or earlier call date. It is also clear that the intention of the statute is to permit the amortization of premium on convertible bonds. The only condition imposed is that the option to convert rest with the owner of the bond. This is made convincingly clear from the identical language appearing in both the House and Senate Committee Reports as follows:

> "The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the

[9] Petitioner also raises no question with respect to respondent's right to amortize the premium on the American Telephone and Telegraph bonds to the earliest call date (R. 20; Pet. Br., p. 5).

> period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, *if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section*" (Italics supplied).
>
> H. Rep. No. 2333, 77th Cong., 2d Sess., p. 80 (1942-2 CB 372, 433-434); S. Rep. No. 1631, 77th Cong., 2d Sess., p 94 (1942-2 CB 504, 576).

The statute incorporates the legislative intent expressed above by providing without qualification that the rules prescribed by Section 125 apply "In the case of any bond" (subsection (a)), and "in the case of the holder of any bond" (subsection (b) (1)).

The term "bond" is defined in subsection (d) of Section 125 as "* * * any bond, debenture, note, or certificate or other evidence of indebtedness * * *."

Subsection (d) further provides that the term "bond" as defined therein "does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

It was stipulated and found as a fact by the Tax Court that the bonds here involved are not within the foregoing exclusion (R. 2-3, 9-10).

Since there is no exclusion in the statute other than that contained in subsection (d) the maxim "*expressio unius est exclusio alterius*" applies. *Jones v. Crosswell*, (4th Cir.), 60 F. (2d) 827, 828.

The bonds here involved fall squarely within the statutory definition and there is no justification whatever for the petitioner's attempt to deny respondent the right to deduct the premium paid thereon.

CONCLUSION.

The decision of the Court of Appeals for the Second Circuit is correct and should be affirmed.

Respectfully submitted,

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Appendix.

Internal Revenue Code:

SEC. 23 DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b) on the bond for any taxable year beginning after December 31, 1941):

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113(b) (1) (H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the ta payer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and Partially Taxable Bonds.*—

(1) *Eligibility to elect, and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a) (1) or (2) is allowable; and

(B) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible

from gross income but with respect to which the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (26 U. S. C. 1946 ed., Sec. 125).

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125-1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer, and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivisions thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * * *

SEC. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * * * *

Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

SEC. 29.125-3. *Methods of Amortization.*—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942; or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method

prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125-4 *Election.*—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall

apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

SEC. 29.125-5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.